Prime Minister

No action on this required now: it will be one of the subjects for discussion at the next E(NI) meeting.

MCS 9/10

Noted policy

cc J. Vereker
A. Walters
A. Duguid

CONFIDENTIAL

Qa 05699

8 October 1981

To: MR SCHOLAR

From: J R IBBS

Nationalised Industries - 1981 Investment and Financing Review

1. At E(81) 29th meeting it was decided that sponsor Ministers should hold further meetings with the Nationalised Industries with a view to closing the gap between the industries' latest forecasts and the financing limits implied by the E Committee decision of 31 July. As invited by Mr Lankester's letter of 25 September the CPRS has worked closely with the Treasury and has also contributed to the briefings for sponsor Ministers for some of the biggest industries. In addition I accompanied Ministers at two of the meetings with Chairmen.

2. The result of this further round of meetings with the industries is that although some reduction has been achieved, largely because assumptions on wage settlements have been lowered, there is still a substantial gap in each of the years of review. For the immediate year of 1982/83 the shortfall has been reduced from £1,334m to £974m. I understand that Treasury Ministers will be consulting the Prime Minister about the extent to which this might be reduced further.

3. I remain convinced that the amount of reduction in his cash requirement that a nationalised industry Chairman will offer or tolerate depends on how strongly he is convinced of the necessity for the reduction. The extent to which Ministers are prepared to press for reductions in turn depends on how they weigh up the pain that a specific reduction would impose on an industry compared with the pain of corresponding options for other industries and the damage to macro-economic prospects caused by an excessive PSBR.

4. The present method of setting EFLs fails to bring out clearly the practical consequences for the industries of specific further reductions. Ministers are not presented with a coherent assessment of the least deleterious way in which industries could achieve their target EFLs. As a result a proposed EFL figure emerges after discussion as 'the lowest possible' whereas infact the position is not as simple or rigid as this and some potential further savings may be missed. There is, of course, a danger that the business implications will be exagerated by the industries in order to preserve further existing bids; alternatively, an industry may refuse to co-operate. These difficulties can only be countered by a sound relationship with the industry, skilful negotiations and firm probing by the sponsor department. All these I believe should evolve from the CPRS recommendations for an improved relationship.

5. For the future a better understanding within sponsor departments of each industry as a business would help to reveal the implications of further cuts and enable better judgements to be made. There is probably neither the time or the knowledge to tackle the problem in this systematic way to arrive at figures for 1982/83. However, in the absence of such information I would myself not easily be convinced that the reduced figures are the minimum obtainable.

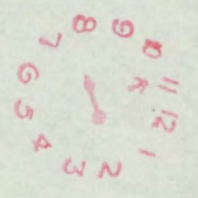
6. One specific area where I believe there may still be some scope for economies in several industries is working capital. While there is little chance of exposing the potential savings in time to meet present EFL deadlines, one way of pressing on towards achieving them would be to arrange for firms of accountants with appropriate experience to review working capital management in some of the major industries. It should be possible to complete such studies quite quickly and to establish the extent of potential savings. The industries could then implement the necessary cash conserving policies in the fifteen months or so remaining to March 1983.

7. Finally, although the financial year 1982/83 is the immediate problem, it is important not to neglect the projected shortfalls

for 1983/84 and 1984/85 in the expectation that these can be solved when they in turn become an immediate problem. Rather than wait for the next IFR review, work should continue now, on the lines suggested, to define realisticly tight medium turn financial paths for the industries, assessed in the light of the business implications for the industries themselves.

8. I am sending a copy of this minute to Sir Robert Armstrong.

JR



-9 OCT 1981

CONFIDENTIAL

J. Vereker
A. Walters
A. Duguid

Nat Ind
NBPM yet

Secretary of State for Industry

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
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5 October 1981

The Rt Hon Leon Brittan, QC, MP
Chief Secretary to the Treasury
H M Treasury
Parliament Street
LONDON
SW1P 3AG

Copies to

E Committee
Sir Robert Armstrong

Dear Leon,

EXTERNAL FINANCING OF NATIONALISED INDUSTRIES

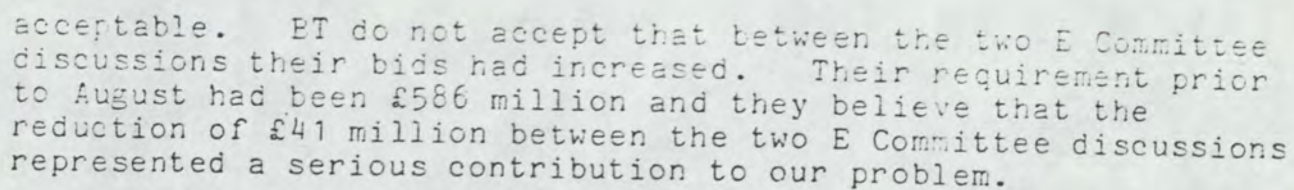
1. I have been back to the nationalised industries for which I am responsible in the light of the discussion in E Committee on 23 September and this letter reports the current position.

BRITISH TELECOM

2. For British Telecom the gaps to be filled in respect of the three financial years 1982/83, 1983/84 and 1984/85 were £248 million, £363 million and £394 million respectively. You and I were also concerned at the possiblity of BT requiring more financing this year than the EFL permitted.

3. BT insist that they have never accepted that the EFL of £380 million for 1981/82 was realistic and believe that they had an understanding that the Department would consider a higher figure this Autumn when the external management consultants had reported. They believe they have done well to contain the projected EFL overrun to £70 million. BT have undertaken to continue to do all they can to improve the position further. I, for my part, have said that they must stay within the EFL that has been set. The gap remains and I shall have to discuss the matter with them further.

4. For 1982/83, Sir George Jefferson believes he can fully meet our needs. He is only able to reach that view by arguing that he should be relieved of the obligation to pay out £90 million (and larger sums in later years) to fund members of the Post Office Superannuation Scheme and that the major part of the proceeds of any BT bond should be used to fill the financing gap remaining after making the savings indicated in paragraph 5 below. You, on your part, could not accept either point as argued and they are both matters for separate consideration. I consider, however, that Sir George's arguments should be allowed some weight in considering whether any eventual EFL shortfall is



acceptable. BT do not accept that between the two E Committee discussions their bids had increased. Their requirement prior to August had been £586 million and they believe that the reduction of £41 million between the two E Committee discussions represented a serious contribution to our problem.

5. BT now offer a staff freeze, savings on capital and working capital and a pay assumption of 5½% (the aim being to settle at 4-5%), only part of the benefit of which would be passed on to customers in the form of lower price increases. These together amount to £110 million. The Department has not worked over these figures but the position for 1982/83 is that BT have found over half - £151 million - out of the £289 million gap between their proposal in July and our own proposed external financing figure of £297 million. We shall now need to consider whether the revised BT proposal is acceptable.

6. For the following years, BT have not produced any proposals but, in the light of the undertaking already received, and other possibilities, I believe I can negotiate substantially lower figures.

POST OFFICE.

7. For the Post Office the 1982/83 gap is £160 million towards which, as you will know from our correspondence, the Corporation have offered £27 million (ie a zero EFL) and have reduced their pay assumption to 4%. I shall be seeing the Chairman later today to examine with him what more can be achieved for that year and what the implications would be for the later years of the IFR. I shall let you know the outcome. Useful further savings could, I understand, be made through a more efficient use of the Post Office's property assets, although this is largely dependent on a relaxation of the rules covering sale and leaseback, a matter on which I believe David Young is already in touch with you.

NATIONAL GIROBANK

8. I shall also write more fully about National Girobank following my meeting with Ron Dearing today. Girobank has reduced its assumptions on pay and is able to offer a zero EFL in 1982/83. This would entail a cut of £4.4 million equivalent to something over 2% of operating costs and there should also be some savings in the later two years. I do not, however, see any likelihood of Girobank being able to make the cuts of 6%, 8%, and 6% respectively in operating costs which your proposal would entail. In this context I note that Girobank has been categorised as non-competitive. This is clearly an error and I shall return to the point when I write to you about the outcome of the meeting with Ron Dearing.

BRITISH STEEL CORPORATION

9. BSC have as you know, put forward no proposals in respect of the various years and therefore the IFR figures, from which Treasury cuts are being imposed, are themselves extremely artificial. I shall not receive the BSC Plan until next month. I have, however, had a frank discussion with Ian MacGregor. He was planning in terms of external financing of £450 million in 1982/83, £200 million in 1983/84 and £10 million in 1984/85. Although in aggregate these figures are within the target E Committee are seeking, the figure for the coming year is much too large. I have told him this. Ian MacGregor has in turn made it clear that, if the cash allocation which he regards as necessary is significantly reduced, he cannot bring the Corporation back to viability: he points out that major closures would in the shorter term cost more cash and that therefore this path provides no solution to our problem.

10. The position, is, I recognise, most unsatisfactory. There is , however, in my view no doubt about Ian MacGregor's determination to do the job for which we appointed him and I am impressed by his firmly stated intention to permit no increases in pay (in money terms) over the three year period which are not clearly met out of genuine productivity improvements. While, of course, all is to play for in the Corporate Plan discussions, it would be wrong of me to accept any reduction in the £350 million figure for 1982/83 in the paper you circulated E.

BRITISH SHIPBUILDERS

11. For British Shipbuilders we also have the problem that to choose figures now means pre-judging Corporate Plan discussions. As you know, BS contributed significantly to the first round of savings by reducing their External Financing Requirement by £60 million but your officials will know that the figures made no provision for the cost of any reduction in naval or merchant shipbuilding capacity or for the additional Intervention Fund likely to be needed to sustain BS's merchant shipbuilding capacity. In further discussion with BS the figures have been revised to take account of the extra Intervention Fund needed.

12. I shall, of course, be examining BS's needs when considering their Corporate Plan but in cash terms over the next three years the provision of Intervention Fund is cheaper than closures. To offset the additional Intervention Fund needed, BS have accepted a saving of £5 million a year which results from lowering their wage assumptions. BS's revised IFR is, therefore, as follows:

	1982/83	1983/84	1984/85	Total
		£m		
March IFR	147	136	88	371
September IFR	130	110	71	311
Additional IF	0	+5	+15	+20
Wage Saving	-5	-5	-5	-15
Revised IFR	125	110	81	316

13. I do not believe that it would be useful to press BS to make further savings. My anxiety is that BS's assumptions in their Corporate Plan are optimistic and that the improvements for 1984/85 may not be secured. You are, of course, aware that over £100 million is included for the Trident submarine facility.

Yours ever

Patrick

1 2 3 4 5 6 7 8 9 10 11 12

- 8 OCT 1981

JU578 cc J. Vereker
A. Duguid
A. Walters

NBPM

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
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Secretary of State for Industry

13 October 1981

The Rt Hon Leon Brittan QC MP
Chief Secretary
HM Treasury
Treasury Chambers
Whitehall
London SW1P 3AG

Dear Leon,

POSTS AND NATIONAL GIROBANK: EXTERNAL FINANCING 1982/83 - 1984/85

As I undertook to do in my letter of 5 October, I have now seen Mr Dearing to press him on whether he could offer any further cuts in his external financing requirements for Posts and National Girobank for the period 1982/83 - 1984/85.

Posts

2 You will recall from my letter of 5 October that Mr Dearing's offer for the postal business was:

	£m		
	1982/83	1983/84	1984/85
External Finance	00	0	0

At our recent meeting Mr Dearing explained that the 1982/83 zero EFL already involved cuts in operating expenditure of £184m, or 7%, compared to the expenditure forecast in the business' Strategic Plan, together with a cut of £102m, or 45%, of the originally forecast capital spend. For the two later years there would have to be similar cuts in capital expenditure as well as reductions in operating costs.

3 I pressed Mr Dearing on whether the business could save more and he agreed that it might be possible to find a further £10m in 1982/83 (as a result of the pay assumption having been reduced from 5% to 4%) and to improve the 1983/84 and 1984/85 external

financing limits to -£15m each.

4 These additional savings would bring the EFLs for the years concerned to:

	£m		
	1982/83	1983/84	1984/85
	- 10	- 15	- 15
Cmnd 8175	- 15	- 15	- 15

I do not think it would be possible to extract any further savings from the postal business, as the capital spend has already been reduced to a level which will mean further delay to the mechanisation programme, retention of the vehicle fleet beyond an economic age and continued use of sub-standard buildings. The first two of these were listed as areas where remedial action should be taken by the Monopolies and Mergers Commission in its Report on the Inner London Letter Post, whilst some buildings already contravene Health and Safety and fire legislation. Mr Dearing added, however, that, if the rules relating to sale and leaseback were modified, he could reduce his external financing requirements in 1982/83 by a further £15m as a result of a proposed sale and leaseback of Postal Headquarters. In the next two years a change in the rules could lead to a further improvement of £30m each year.

5 I recognise that the latest offer still falls short of the external financing arrangements that the Postal business was asked to achieve on the basis of cuts of 6, 8 and 6% respectively in operating costs. I have therefore explored with Mr Dearing the possibility of further cuts. For reasons explained above, I do not see any scope for further cuts in investment in fixed assets. So far as working capital is concerned, the Post Office does not produce goods on its own account and working capital consists almost entirely of debtors and creditors. There is, I understand, very little scope for improvement in debtors. As regards creditors the Post Office is already taking steps such as delaying payments to overseas administrations. Its principal creditors are, however, within the public sector and improvement here would not help the PSBR.

6 80% of the operating costs of the Postal business are labour related and I do not believe that it would be realistic to reduce the pay assumption below 4%. As I mentioned in my letter of 24 September on tariffs, the Post Office is aiming for reductions in operating hours to reduce total labour costs. These savings

have so far been achieved largely by reducing overtime, but I have pressed Mr Dearing to consider the possibility of reductions in manning. Of course the financial benefits from this would take longer to materialise - indeed the position would worsen at the outset if redundancy payments were made - and I do not think it would be reasonable to press for much more in this area. In any event the savings already planned to achieve an EFL of -£10m in 1982/83 are consistent with a reduction in real unit costs of more than the 2% we have built in to the first year of the revised performance aim.

7 Apart from severe cuts in services, which besides being politically very sensitive would take time to negotiate, the only other possible way of bridging the gap would be through a tariff increase. To raise the additional £135m required in 1982/83 would need an increase of 6p/4p on basic postal rates in early January 1983, if the annual interval of tariff increases were not to be shortened. Besides being a risky policy due to the possibility of high traffic deterrence, the Board's public commitment to contain price rises to within the level of inflation makes it inconceivable that the Post Office would agree to such a course. Politically, too, such a course would be very dangerous.

National Girobank

8 So far as the National Girobank is concerned, I must start by saying that there is no defensible reason for it to be placed in the 'non-competitive' category. Girobank is in full competition with other Clearing Banks and there is evidence that it has influenced the clearers to improve their service to the public in a number of respects. In any event, it would be quite impossible for Girobank to achieve cuts in operating costs of £12m, £18m and £15m in the years 1982/83 to 1984/85 as required from non-competitive industries. If the repayment entailed had to be paid out of reserves, public sector finance would not benefit, since Girobank would require a compensating increase in its capital base in order to maintain its free capital ratio at the level regarded as necessary by the monetary authorities. Even with smaller costs, it is probable that by 1983/84 Girobank would require a capital injection to maintain its free capital ratio.

9 Moreover, I think it is relevant that Girobank has been subject to the special tax on banking deposits, which has not affected any other nationalised industry. Whilst it has been to some extent compensated by injections of additional capital, it does have additional debt to finance as a result of the levy.

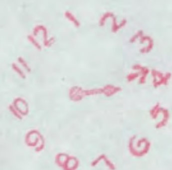
10 Mr Dearing has offered a zero EFL for Girobank for each of the three years of the IFR. This would entail a cut of just over 2% in operating costs in 1982/83, as required of competitive industries. Over the IFR period as a whole Girobank's EFLs

would be improved by some £3m compared to those agreed last year for Cmnd 8175. The improvement in Girobank's 1982/83 financing limit has been achieved by a reduction in its pay assumption from 10% to 6½%. Given Girobank's traditional pay ties with telecommunications, which it hopes to break next year, and the levels of pay in competing banks, I do not think it would be realistic to reduce its pay assumptions further.

11 In conclusion, although I recognise that the outcome may be disappointing to you, both Posts and Girobank have made cuts which have brought their combined EFLs over the IFR period to within £2m of those agreed in Cmnd 8175. I believe that in achieving this the new Post Office Corporation has done as much as could reasonably be asked of it and I do not think it feasible to seek any further reductions.

12 Copies of this letter go to the Prime Minister, to recipients of my letter of 24 September and to Robin Ibbs.

3 OCT 1981



Yours ever

Patrick

CONFIDENTIAL

NBPM yet

SCOTTISH OFFICE
WHITEHALL, LONDON SW1A 2AU

cc J. Vereker
A. Duguid
A. Walters

Rt Hon Leon Brittan QC MP
Chief Secretary
HM Treasury
Treasury Chambers
Parliament Street
LONDON SW1

12 October 1981

Dear Chief Secretary,

NATIONALISED INDUSTRIES EXTERNAL FINANCING REQUIREMENTS: SCOTTISH ELECTRICITY BOARDS AND SCOTTISH TRANSPORT GROUP

At E Committee on 30 September sponsoring Ministers were asked to review the external financing requirements of their industries in the years ahead in an attempt to secure further reductions.

For the Scottish Electricity Boards the forecast requirements as set out in the Nationalised Industries IFR in July were as follows (at the Boards' estimated outturn prices):- £m

	1982/83	1983/4	1984/5
NSHEB	51	44	48
SSEB	265	280	242

Prior to the 30 September meeting the Boards had already offered overall reductions leading to the following revised forecasts:-

NSHEB	49	43	34
SSEB	216	274	256

These changes mainly reflected a review which SSEB had undertaken of the likely profile of cash requirements for Torness. Alex Fletcher discussed these forecasts with the Boards last Monday and they have now submitted a further revision, which shows the following requirements:

NSHEB	49	36	23
SSEB	216	251	222

These further reductions arise partly from lower assumptions on pay and on coal prices. The Boards are now assuming a 6% settlement next spring with increases in line with inflation thereafter. For coal they are assuming a 7% price increase this November and increases in line with inflation. In addition SSEB proposes to reduce its oil stocks by one-third by March 1983 and to postpone one of the transmission lines related to Torness, while NSHEB proposes to cut its manpower and cut or re-phase its planned investment. Both Boards have however had to assume higher interest rates

this year and next than in their original IFR submissions, and since their interest costs are roughly double their payroll costs this has cut the savings they can offer by approximately £15m in 1983/4 and 1984/5.

The Boards have assumed that work at Torness will continue on its present timetable and their inflation and tariff assumptions are unchanged from the IFR. On tariffs the Boards are assuming 11% increases in each of the next three years, compared with assumed inflation rates of 12%, 10% and 10%. The Boards have stated that in the absence of any financial target and of any information about our intentions for coal prices or domestic gas prices after next year their projected tariff increases merely represent working assumptions. If a different tariff policy is subsequently agreed, or if EFLs requiring real price increases are set for NCB, they expect their external financing figures to be adjusted accordingly.

I recognise that these reductions do not go as far in 1983/4 and 1984/5 as those your outlined in E(81)79. The Boards consider that they cannot propose cuts equivalent to 6%, 8% and 6% of operating costs when some 70% of their operating costs (fuel, rates, interest and depreciation) are beyond their control except in the long term. They have also expressed doubts, in view of the many uncertainties surrounding the figures, about the value of agreeing precise forecasts this far ahead. I note that Nigel Lawson, in his letter of 11 September, has proposed for this reason that no adjustment should be made to the White Paper forecasts for the NCB for the later years. I hope therefore that you will agree that further argument with the Boards about these very speculative forecasts would not be fruitful.

Finally I should point out that the revised forecasts which the Boards have already provided for 1982/3 may require amendment in the light of the revised assumptions which the Board has adopted, and may also be affected by any decisions we take on industrial tariffs or strategic fuel stocks.

The position of the Scottish Transport Group is that the following substantial savings have already been offered:

£m

1982/3	1983/4	1984/5
3.5	4	4

These figures compare favourably with the savings of £3m, £5m and £6m respectively which they were asked to make. The Group has worked hard in recent years to reduce the unit costs of the business and there is no scope for current cost savings in their bus operation which accounts for the bulk of their business. The savings have therefore had to be found mainly by cutting bus investment which had already been reduced substantially in their original investment review to take account of savings in capacity resulting from a substantial revision of services. Further savings in bus investment cannot be found in 83/4 onwards without seriously damaging the Group's prospects of remaining competitive and efficient in the longer term. Bearing in mind, moreover, that the Group is already earning a 5% real rate of return on its bus investment, I would find it impossible to defend further cuts.

I appreciate that the savings which you have asked me to find in STG are based on figures which assumed that there would be no new tonnage investment over the period of the review. My understanding

when this matter was considered in July was that, although specific consideration had still to be given to STG's case for new tonnage, investment in new ships would be allowable. Just prior to the meeting on 30 September however, your officials suggested that there could be no question of including investment in tonnage at all. If all tonnage investment were removed in addition to the savings which the Group have already offered, it would amount to reductions in the EFL of £6.2m, £11.6m respectively in 1982/3 and the two subsequent years. This would represent reductions of 21% increasing to 31% and as such is unacceptable to the Group and indeed to me. I still fully intend to investigate thoroughly the justification for the Group's new tonnage proposals but I do not want to see that option closed.

What the Group can offer at this stage is some postponement in their new tonnage investment in 1983/4 and 1984/5 so that the figures for the next three years can be abated to £3m, £3.4m and £4.8m respectively. However, the effect of cutting investment is to increase the Group's tax liability and reduce the Group's chance of meeting their financial target. Accordingly, the Group have suggested offsetting some of these investment savings on new tonnage. As a result, the Group are prepared to yield up the following reductions:

1982/3	1983/4	1984/5
£3.5m	£6.2m	£6m

These reductions amount to 12%, 17½% and 17% respectively on the EFLs proposed for these years.

You may care to note that I have still to give further consideration to the question of the level of revenue support which local authorities offer towards the Group's bus operations. These payments are part of the EFL calculation but are not a matter over which the Group have control. It is still unclear at this stage whether local authority support payments are likely to vary from the level we have already indicated to you, and I shall have to give this specific consideration once it becomes clear what line Lothian Region in particular are likely to adopt.

I am copying this letter to members of E Committee.

Yours sincerely

A MacKenzie

Approved by the
Secretary of State and
signed in his absence.

13 OCT [illegible]