

Prime minister cc JD 2



WM 27/8

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PRIME MINISTER

PRIVATE FINANCE

Your personal minute of 28 July commissioned a fresh review in E(DL) of progress and prospects on privatisation for action in this Parliament and preparation for the next. In my letter of 11 August to the Home Secretary I also invited colleagues to report by the end of October on progress with contracting out in the wider public sector, and on further measures which might be taken. In addition to these two exercises, I asked my officials to prepare the attached report on progress on the introduction of private capital into the public sector.

2. The criteria for the direct introduction of private capital into the public trading sector were worked out in NEDC last year. We are pressing forward wherever there appear to be advantages to compensate for any additional cost. The picture is quite encouraging. Although the number of schemes which have so far gone ahead is limited, a number of new ideas are coming forward and being examined. I am sure that colleagues should be on the look out for more, especially as they prepare the planned reports on privatisation and contracting out. For example, there may be cases where immediate privatisation is not possible but a joint venture might be a helpful interim measure.

3. Progress on the use of private capital in the public services has been slower but there are one or two relatively well-known examples eg the experimental work going forward on road construction and maintenance. But I am sure that more schemes could be found if the scope for them were to be examined imaginatively and thoroughly.

4. If there are other examples and areas not mentioned in the attached report, the Treasury would be only too willing to look at them.

5. I am copying this letter to other members of Cabinet, to John Sparrow and Sir Robert Armstrong.

(G.H.)  
27 August 1982



## PRIVATE FINANCE : PROGRESS REPORT

Note by the Treasury

1. This note sets out the position on "private" or "unconventional finance" ie finance raised by public sector bodies direct from the markets rather than indirectly through the Government. It does not cover privatisation proper on which the Prime Minister has recently initiated a new exercise or contracting out which is the subject of a separate exercise set in hand by the Chancellor.

PUBLIC TRADING SECTOR

2. To increase the exposure of the nationalised industries, and other public sector trading bodies, to market disciplines the Government has encouraged them to look for ways of tapping the capital market direct eg by bond or project finance which would bring market pressures to bear on the industries and so secure greater efficiency and improved performance. The value of such schemes depends on their meeting certain key conditions. These were formulated in the NEDC discussions last year as:

- First, decisions to provide funds for investment must be taken under conditions of fair competition with the private sector, eschewing links with the rest of the public sector, Government guarantees or commitments or use of monopoly power which result in offering investors a degree of security significantly greater than available on private sector projects;
- second, such schemes should yield benefits in terms of improved efficiency and profit from additional investment commensurate with the extra cost of raising risk capital from financial markets.

3. The purpose of these conditions is to ensure that market pressures determine to the maximum extent possible the initial allocation of



investment funds and provide continued pressure for improved performance either by involving the private sector in the operation and management of the asset or by relating the investors' return directly to improved performance.

Department of Transport

(a) Rail

4. A Working Party (Department of Transport, BRB, Morgan Grenfell and Treasury) are on the point of reporting on two ideas: private finance for a dedicated Victoria/Gatwick rail link and for electrification. The report's conclusions will need to be discussed by Ministers.

5. But further possibilities are coming forward in the rail field eg for franchising and joint ventures and more may arise when the Serpell Committee has reported.

(b) Other Transport Industries

6. There have been two recent initiatives in setting up 51 per cent private sector owned subsidiaries to finance specific investment projects. BTBD have gone into partnership with CY Tung to develop facilities at Southampton and BWB have entered a partnership with Caywood Hargreaves to move slag on the Aire-Calder canal. The future of BWB's initiative is currently under discussion and may yet prove inadequately based to justify treatment as a private sector venture.

Department of Energy

(a) Oil

7. BNOC is being privatised.

(b) Gas

8. The Department of Energy's main priorities are the abolition of the



monopoly/monopsony, the sale of BGC's onshore and offshore oil interests and the disposal of the appliance retailing business. All this is causing considerable difficulty with Sir Denis Rooke and the Department believe there is nothing to be gained from an effort to find ways of involving private finance in the main business of gas supply. However, the Department are proposing to press the Corporation to hive off all activities not directly related to the main business of gas supply and to make this one of the objectives of the Corporation.

(c) Coal

9. Department of Energy's view remains that any moves of this kind are likely to run into strong opposition from the NUM and that for that reason alone they should not be pursued this year.

(d) Electricity

10. The Bill permitting private generators of electricity is now in the legislative programme for the next session. This will place the Electricity Boards under a statutory obligation to make available their transmission and distribution systems to private generators of electricity on fair terms.

11. A consultants' report on the feasibility of major combined heat and power schemes in up to nine cities will be coming forward this month but the forecast rates of return do not look likely to be attractive generally to private investment.

Department of Industry

(a) British Telecommunications

12. The decision to privatise British Telecommunications effectively overtakes any proposals for introducing private capital into BT through such devices as the BT Bond. By exposing BT directly to market forces, privatisation obviates the need for other more artificial devices intended to bring such pressures to bear, provided we continue to press ahead with our plans for liberalisation in other directions.



(b) Post Office

13. In the case of the Post Office the Secretary of State for Industry is reviewing possibilities, including a programme of disposals or joint ventures for the Crown Offices, joint ventures in the parcels field and setting up a property subsidiary with private participation to manage the Corporation's property estate.

(c) Other Industries

14. In the case of steel and ship builders, the object of policy is to move as rapidly as possible towards a situation in which total privatisation is possible and to dispose of parts of the businesses, where possible, on the way.

Department of Trade(a) British Airways

15. The object is to privatise as soon as practicable.

(b) British Airports Authority

16. A joint BAA/DOT/Treasury Working Group is to examine in detail the two most promising ideas for private sector finance to emerge from an examination by merchant bankers. These are i) a performance bond on the lines recently proposed for BT and ii) equity finance linked to income from duty free and other airport concessions. The working group will report in October.

Department of the Environment(a) Water

17. The Secretary of State for the Environment is keen to see the introduction of private finance in the water industry but the main proposal examined so far - a private sewage treatment company for Merseyside - seems to offer little or no scope for efficiency savings



or other benefits to outweigh the extra cost of private finance. But the conclusion follows from the physical characteristics of this particular scheme and would not necessarily apply to other areas of water authorities' activities.

#### PUBLIC SERVICES

18. The criteria are less clear cut in this area but the responsible authorities (whether central or local government or authorities such as the NHS) will want to ensure either that the involvement of the private sector imposes no extra outlay or that where it does, this is outweighed by greater efficiency, improved service etc.

#### Department of Transport

##### (a) Roads

19. Following discussions in E Committee the Secretary of State for Transport has been authorised to consult construction companies and other interests about the possibility of tapping private sector capital as a reinforcement to conventional public sector funding of road construction.

20. The scheme that has figured most in these consultations and in the work of the Civil Engineering EDC is one in which the private investment would be remunerated by a royalty per vehicle paid by the Department for a fixed period after the road is opened.

21. Until the results of the consultations are known the additional cost which may be involved compared to conventional funding cannot be assessed nor can the efficiency gains to be achieved. But the construction companies opening position is that the privately financed project should be additional to those financed by conventional public expenditure and should benefit from guarantees from the Government as to their minimum rate of return.



22. A number of local authority privately financed road schemes have also been put forward, their justification is not entirely clear. Some local authorities may see them as a way to avoid capital control. The Department of Transport and the Treasury are discussing how these should be handled.

Department of the Environment

(a) Government Construction

23. A decision was taken earlier this year not to construct the International Conference Centre with private funds because of the cost. More recently, the Secretary of State for the Environment has suggested that the Bridge Street Site should be redeveloped with private funds. The scheme has yet to be examined in detail.

24. Whether private funds would be good value depends largely on whether substantial part of the building will be occupied by the public sector (in this case Parliament). If so, then public funds for at least part of the development would almost certainly be the cheapest option. If, on the other hand, the development will be occupied almost entirely by the private sector, then outright sale of the site would appear to be an obvious option.

(b) Inner Cities

25. The Secretary of State for the Environment has also been making considerable efforts to attract more private finance into the inner cities. He has invited local authorities to bid for the new Urban Development Grants, announced in the Budget, which will be paid towards projects offering a high contribution by the private sector. Bids have been invited by the end of September for implementation in 1983-84. A similar scheme was operated for derelict land grants in 1982-83 and about £10 million of grant is likely to be paid out on development projects involving more than £70 million of private money.



(c) Housing

26. A number of schemes for the use of private finance in housing association projects are under consideration. In most cases, schemes offer no offsetting benefit to the higher cost, in terms of Government grant, of using private finance. However, approval has recently been given to a pilot scheme in which an insurance company will finance most of a housing association shared-owner project instead of the housing corporation in return for a claim to capital appreciation on the remaining share of the property.

(d) Other

27. The Department of the Environment also recently published a pamphlet "Bringing in Business" which describes a variety of individual schemes in which local authorities and other public bodies are working or have worked together in partnership with private sector developers and financial institutions. The aim of the brochure is to show to other institutions, developers and local authority what can be achieved and to encourage them to exploit the many similar opportunities that exist.

Department of IndustryFactory Building

28. Discussions have taken place between officials about the appropriate criteria for greater private sector involvement in the Government's factory building programme. It has been agreed that short term rent guarantees and leases may be appropriate ways for the various agencies to act as catalysts in stimulating the private sector to invest in areas where they would otherwise not contemplate doing so. But long term lease backs and the various tax based schemes of finance offer little more than a more expensive way of raising Government finance.

Department of Health

29. For the near future policy is to encourage provision and financing



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of health care in the private sector rather than privatisation of the NHS itself or to seek private financing for NHS development. However privatising the general ophthalmic, dental and pharmaceutical services is under consideration. So too are various aspects of contracting out: these could have particular importance in this area.

HM TREASURY  
19 August 1982

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