

21 October 1983

Policy Unit

PRIME MINISTER

COMPETITION AND PRIVATISATION

The Chancellor's July initiative is in danger of losing its way. We will certainly fail to meet our objectives on privatisation and competition during this Parliament if we accept the disappointing replies from Departments.

The Treasury's paper for E(A) does introduce a sense of urgency. It is now essential for you to put your full authority behind the privatisation programme.

We suggest that at the E(A) meeting, you:

1. Endorse Nigel's paper calling for a co-ordinated timetable for action for this Parliament.
2. Announce your intention of chairing regular progress meetings to ensure that the momentum is maintained.
3. Request Sponsor Ministers who have not yet reached final decisions to produce timetable options for their industries.

This will give John Moore sufficient backing to ensure that Sponsor Ministers expose their thinking and, equally importantly, provide the political commitment which appears to be required before Sponsor Departments carry out the detailed work which this programme requires.

It is not as if the Chancellor's July letter began this exercise. Departments should have been thinking about privatisation and competition since 1979. By December, we shall be 6 months into our second term.

We cannot allow Peter Walker and others to opt out of this exercise. Preferred solutions for gas and electricity are still being developed, but Peter could at least produce alternatives which can be modified later on. We cannot agree a co-ordinated programme which omits the energy industries. Peter may argue that these issues have to be handled with great secrecy, but there is no secret about our Manifesto commitment to introduce private capital into the gas and electricity industries.

To give you some idea of the lack of commitment in Departments, I attach a copy of John Redwood's report on the British Leyland submission.

The replies from Departments have also failed to take proper account of the points mentioned in Nigel's paragraph 5, such as the introduction of competition and the treatment of the loss-making industries. Some of these were explored at the Chequers seminar and in earlier reports, eg from the CPRS. But they still do not seem to have sunk in. We attach a summary of these points which might help John Moore to extract proper responses on the second round.

Would it be useful to circulate these to colleagues?

Agree?

FERDINAND MOUNT

fm
The British Leyland memo under private cover from me to Norman Tallett only. The other memo on competition can be circulated *not*

Dave AT
24/10

MR MOUNT

BRITISH LEYLAND

The Department of Trade and Industry's submission concerning privatisation plans for British Leyland are woefully inadequate and conceal potential risks and dangers for the Government if it continues to follow Department of Industry policy.

1. Jaguar

There is no reason why the whole of Jaguar should not be sold in 1984. The proposal that one quarter of Jaguar should be sold then with the remainder floated in 1985 is based on the premise that Jaguar's profitability will continue to improve and that therefore a higher sale price will be achieved by delay for the bulk of the equity sale. Investors are quite able to discount ahead, and the prospectus in 1984 can make clear the management and Department of Industry's view of the rising trend of profitability.

2. The sale of Unipart is possible in 1984, and there should be a clear resolve to dispose of it within that calendar year.

3. Four-wheel drive vehicles

The British Leyland Board and DoI have decided to link the fortunes of the four-wheel drive operation to those of Leyland Trucks. Leyland Trucks is hopelessly adrift, probably heading for losses of around £100 million in the current year, when taking into account interest charges. There is little common ground between the trucks business and the four-wheel drive operation. The four-wheel drive business is losing market share rapidly, but still has some good products and a prospectus can be drawn up on the basis of it being profitable in the future. This should be done in 1984 and the business sold before it:

- (a) is contaminated by the general problems of the group;
- (b) has insufficient capital to renew its model range at a time of intensifying competition;
- (c) suffers from a lack of management concentration on its problems in view of the greater problems elsewhere.

Austin Rover

The prospectus for Austin Rover which DoI and BL are writing envisages sale to investors after 1990. It is a bogus prospectus.

Their cash flow projections assume a continuing outward flow of cash from the business until some magic in 1990 transforms the business into profit and modest cash inflow. The figures conceal the fact that Austin Rover is to embark on a very expensive, 3 new model programme between 1984 and 1989, where the ultimate paymaster must be the taxpayer in view of the continuing drain on the business's finances, and the gross deterioration in the balance sheet which will take place on DTI figures over that time period.

We require from the DTI a paper setting out the detailed options for the future of Austin Rover. These options should include a strategy for speeding up the disposal of Austin Rover on the back of the successful introduction of the Acclaim, Metro and Maestro models. This disposal could take place within the next 2 years and may entail a dowry. A second option should be to continue with Government ownership of Austin Rover, but with a reduced new model-building programme, and a tapering of the financial commitment of the Government under the Varley-Marshall assurances. The third option would be a splitting up of the different operating units of Austin and Rover, and the partial sale of some of these units. The fourth option would be to explore the scope for collaboration with a foreign car producer and a sharing of the risks and capital. There has been little work on the likely future shape of Honda involvement in BL following the XX.

Without such a paper setting out the options for Austin Rover, it will be extremely difficult to judge the commitment to the privatisation plans within the DTI and BL. The Government will be faced with the need to sign a blank cheque, where the numbers involved in Government support could become very large indeed if any small thing goes wrong with Austin Rover strategy as currently set out.

5. Truck and Bus

The current state of the truck business at BL illustrates the dangers of delaying disposal in the belief that things will get

better. Some years ago the case for disposing of trucks when it was still breaking even was rejected on the grounds that the business would strengthen. We are now heading for the worst trading year on record, and there is no sign of any relief. There needs to be a more rapid exploration of the options for collaboration with other companies in the truck division, and also a more serious exploration of the possibilities of sale of the truck business, even with a dowry if necessary.

Conclusion

The strategy towards BL is drifting. The statements about the extent of privatisation commitments are misleading and as the DTI submission on BL illustrates, there is a lack of commitment to the policy by both BL and the DTI.



JOHN REDWOOD

COMPETITION AND PRIVATISATION

In the light of the responses to the Chancellor's letter of 25 July, it may be helpful to re-emphasise certain points which have been made in previous debate. It is hoped that these points will assist in the forthcoming discussions between the Financial Secretary and departments concerned with privatisation.

1. Our objective is to displace state ownership and control both by private ownership and, wherever possible, by the discipline and pressures of the marketplace. The introduction of competition is therefore an essential element of our policy and one which is more relevant for the public utilities and so-called "natural monopolies" than for manufacturing industries where a competitive environment already exists. We must ensure that all barriers to competition, including legislative barriers, are removed and that structural changes are considered which encourage competition.

Using Existing Legislation

2. To avoid crowding the Parliamentary timetable, we must use to the maximum the powers under existing legislation to sell off parts of the nationalised industries, particularly those areas which can operate in a competitive environment.

Splitting up Conglomerates

3. The claimed benefits for vertical integration in many state industries should be critically examined. Large, unsuccessful conglomerates should not be held together in the belief that in due course they will become more successful and profitable overall, enabling sale of the whole. Experience shows that it is usually better to split them up and gain the benefits from management diversity and access to private capital for the separate bits.

Reducing the Natural Monopoly

4. It is often possible to separate the parts of a nationalised industry which could operate in competitive markets from those which are natural monopolies. In most cases, the extent of natural monopoly is small and confined to the common-carrier infrastructure. The natural-monopoly elements can be left in the public sector, or privatised and regulated. Whichever route is preferred, we should do everything possible to provide a competitive environment for those who buy from or sell to a natural monopoly.

Long-Term Contracts and Franchising

5. Long-term contracts for the use of the services of a common carrier, in effect leasing part of the network, can be an effective way of increasing market pressures. Similarly, franchising does allow for periodic competition and gives scope for the entry of new producers within a network industry.

Regionalisation

6. Although regionalisation would produce local monopolies in those industries where effective competition is not possible, there is scope for stimulating competition between the management of different regions by means of inter-regional comparisons of price and performance. The opportunity for innovation and emulation amongst regional companies does offer a better chance for a more dynamic and efficient industry than a centralised organisation. Economies of scale are unlikely to be prejudiced by a regionalised industry. The problems of economic and union monopoly power are more likely to be tackled by a regionalised system of independent, privatised companies.

Regulation

7. There is a need to keep the requirements for regulation to a minimum. There may be a need to provide protection for developing competition until it is able to compete on fair terms in the market-place. In general, however, a system of regulation by exception which is independent of Government is to be preferred. This reduces the bureaucratic and administrative activities of the regulatory agency, and enables it to concentrate on those cases where abuse of power is in question. Although local monopolies will still require some degree of regulation, a simpler system is more likely if the performances of a range of private companies can be compared.

Loss-Making Industries

8. We should not be mesmerised by the idea of making the business profitable before selling it. Experience has shown that on many occasions, losses grow worse with time, making disposal more difficult, whilst we believe that private ownership is more likely to achieve the business's recovery more rapidly. If the business is never likely to be profitable, then the City are the best judge of the real worth of the assets.

Waiting for Better Figures

9. In particular, sales should not be held up on the grounds that the following year's profits are likely to be better, thus leading to a higher sale price. Markets are quite able to discount ahead if profits forecasts can be proposed in a credible way. Similarly, we should not pump in subsidy in order to achieve a sell-off price that looks good in the House of Commons.

Transparency of Subsidy

10. We do need to appreciate, however, the likely consequences of privatisation in such cases where we are making an implicit decision about potential closures. The desired balance between commercial criteria and social objectives must be made explicit. This will usually require a greater degree of transparency on cross-subsidisation, in order that we can identify and decide the level of support which an uneconomic social service should receive.

Writing off Debt

11. Privatisation should not be held up through alleged difficulties with the level of debt. In many cases, the money has already been lost and it makes sense to write off a substantial proportion of the debt in order to give the new business a better balance sheet if it is then being sold to new owners.

FILE

CONFIDENTIAL

da



cc CDO BOE
 MAFF WD
 BOT SO
 COL DTN
 DTI NIO
 HMT
 FSO

10 DOWNING STREET

From the Private Secretary

24 October 1983

Dear John,

Competition and Privatisation

The E(A) meeting is now being rearranged. Meanwhile the Prime Minister has suggested that colleagues might like to see the attached note produced by the Policy Unit.

I am copying this to the Private Secretaries to members of E(A) and to Andrew Hudson (Financial Secretary's Office).

*Yours sincerely
 Andrew*

Andrew Turnbull

John Kerr, Esq.,
 HM Treasury.

CONFIDENTIAL

da

COMPETITION AND PRIVATISATION

In the light of the responses to the Chancellor's letter of 25 July, it may be helpful to re-emphasise certain points which have been made in previous debate. It is hoped that these points will assist in the forthcoming discussions between the Financial Secretary and departments concerned with privatisation.

1. Our objective is to displace state ownership and control both by private ownership and, wherever possible, by the discipline and pressures of the marketplace. The introduction of competition is therefore an essential element of our policy and one which is more relevant for the public utilities and so-called "natural monopolies" than for manufacturing industries where a competitive environment already exists. We must ensure that all barriers to competition, including legislative barriers, are removed and that structural changes are considered which encourage competition.

Using Existing Legislation

2. To avoid crowding the Parliamentary timetable, we must use to the maximum the powers under existing legislation to sell off parts of the nationalised industries, particularly those areas which can operate in a competitive environment.

Splitting up Conglomerates

3. The claimed benefits for vertical integration in many state industries should be critically examined. Large, unsuccessful conglomerates should not be held together in the belief that in due course they will become more successful and profitable overall, enabling sale of the whole. Experience shows that it is usually better to split them up and gain the benefits from management diversity and access to private capital for the separate bits.

Reducing the Natural Monopoly

4. It is often possible to separate the parts of a nationalised industry which could operate in competitive markets from those which are natural monopolies. In most cases, the extent of natural monopoly is small and confined to the common-carrier infrastructure. The natural-monopoly elements can be left in the public sector, or privatised and regulated. Whichever route is preferred, we should do everything possible to provide a competitive environment for those who buy from or sell to a natural monopoly.

Long-Term Contracts and Franchising

Long-term contracts for the use of the services of a common carrier, in effect leasing part of the network, can be an effective way of increasing market pressures. Similarly, franchising does allow for periodic competition and gives scope for the entry of new producers within a network industry.

Regionalisation

Although regionalisation would produce local monopolies in those industries where effective competition is not possible, there is scope for stimulating competition between the management of different regions by means of inter-regional comparisons of price and performance. The opportunity for innovation and emulation amongst regional companies does offer a better chance for a more dynamic and efficient industry than a centralised organisation. Economies of scale are unlikely to be prejudiced by a regionalised industry. The problems of economic and union monopoly power are more likely to be tackled by a regionalised system of independent, privatised companies.

Regulation

There is a need to keep the requirements for regulation to a minimum. There may be a need to provide protection for developing competition until it is able to compete on fair terms in the marketplace. In general, however, a system of regulation by exception which is independent of Government is to be preferred. This reduces the bureaucratic and administrative activities of the regulatory agency, and enables it to concentrate on those cases where abuse of power is in question. Although local monopolies will still require some degree of regulation, a simpler system is more likely if the performances of a range of private companies can be compared.

ii. Loss-Making Industries

We should not be mesmerised by the idea of making the business profitable before selling it. Experience has shown that on many occasions, losses grow worse with time, making disposal more difficult, whilst we believe that private ownership is more likely to achieve the business's recovery more rapidly. If the business is never likely to be profitable, then the City are the best judge of the real worth of the assets.

Waiting for Better Figures

9. In particular, sales should not be held up on the grounds that the following year's profits are likely to be better, thus leading to a higher sale price. Markets are quite able to discount ahead if profits forecasts can be proposed in a credible way. Similarly, we should not pump in subsidy in order to achieve a sell-off price that looks good in the House of Commons.

Transparency of Subsidy

10. We do need to appreciate, however, the likely consequences of privatisation in such cases where we are making an implicit decision about potential closures. The desired balance between commercial criteria and social objectives must be made explicit. This will usually require a greater degree of transparency on cross-subsidisation, in order that we can identify and decide the level of support which an uneconomic social service should receive.

Writing off Debt

11. Privatisation should not be held up through alleged difficulties with the level of debt. In many cases, the money has already been lost and it makes sense to write off a substantial proportion of the debt in order to give the new business a better balance sheet if it is then being sold to new owners.