

COVERING CONFIDENTIAL



Treasury Chambers, Parliament Street, SW1P 3AG

D R Norgrove Esq
 Private Secretary
 10 Downing Street
 London
 SW1

NBP

Dear David,

9 April 1986

**DISCUSSIONS WITH NATIONALISED INDUSTRIES'
 CHAIRMEN'S GROUP (NICG)**

To keep colleagues in touch with current discussions that he is having with the NICG, the Chief Secretary has asked me to circulate the following:

- (a) Notes of his meetings with the NICG on 28 February and 6 March 1986.
- (b) NICG letter of 24 March about Board members' pay.
- (c) NICG letter of 27 March 1986 about the Byatt Report on the nationalised industries and accounting for economic costs and changing prices.
- (d) Chief Secretary's letter of 3 April 1986 replying to (b) and (c) above.
- (e) Chief Secretary's letter of 3 April 1986 about the relationship between the Government and the nationalised industries.
- (f) Chief Secretary's letter of 4 April 1986 about nationalised industry Board members' terms of appointment.

2 The Chief Secretary will write to colleagues in due course about the timing of the publication of the Byatt Report and how it should be presented.

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... I am copying this letter and enclosures to the
Private Secretaries of the members of E(NI) and to
Michael Stark (Cabinet Office).

Yours,

Jill

JILL RUTTER
Private Secretary

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NOTE OF A MEETING HELD IN THE CHIEF SECRETARY'S ROOM
ON FRIDAY, 28 FEBRUARY

Present:

Chief Secretary
Mr Monck
Mr D Moore
Sir Robert Haslam - NICG
Mr P Jones - NICG
Mr Driscoll - NICG

TERMS OF APPOINTMENT OF NATIONALISED INDUSTRY BOARD MEMBERS

The Chief Secretary said that he had completed discussions with Ministerial colleagues about the NICG's note on board appointments. There were two points of general background worth touching on. First, he thought it worth emphasising that Ministers did not have freedom of action in this field. Board members were appointments under the Crown and appointments could only be offered within the terms of the statutes of the individual industries. Existing statutes (with the exception of LRT) did not allow advance promise of compensation to be given and any compensation would have therefore to be on ex gratia basis. Existing statutes (other than NCB and Electricity GB) allowed dismissal provision to be put into instruments of appointment; the statutes in the case of NCB and Electricity GB allowed only for fixed terms of appointment. Second, he wanted to emphasise that while general discussions with the NICG on principles were helpful, individual terms of appointment were a matter for negotiation between sponsor Ministers and individual prospective board members.

2 Sir Robert Haslam said he recognised that without a general Bill, the existing statutory framework of the nationalised industries was to some extent a constraint. Nevertheless the proposals in the NICG's paper were intended to be of general application and to the extent changes were needed to individual industry statutes they should be considered as and when the opportunity arose.

3 On the specific proposals in the NICG's note the Chief Secretary said that the Government had no difficulties in accepting the proposal on the selection and appointment of chairmen (1); and the written statement of terms and conditions of appointment (4). The Government were also content to accept the proposals on declaring offices vacant (7); and resignation (8). But it had to be recognised that these latter two proposals implied tidying up legislation which would have to be considered as and when the opportunity arose.

4 Turning to the selection of board members, the Chief Secretary said that it was the firm view of all his colleagues that Ministers' independence in appointing board members could not be restricted. That said, he would always expect the sponsor Minister to be in close touch with the chairman and in many cases the chairman would make proposals which the Minister would be happy to accept.

5 Sir Robert Haslam said the NICG were not suggesting there was any question of the Minister not making the appointment. Their concern was the behavioural pattern underlying the appointment. Their key concern was that the Chairman had to be in charge of and responsible for his Board. If the Board put forward a candidate the Secretary of State naturally had a right of veto. Equally, the Board would always consider candidates suggested by the Secretary of State. What was at issue was the right of the Secretary of State to appoint someone not acceptable to the Board. He recognised that in practice this was likely to be a very limited area of dispute since the Secretary of State who insisted on appointing a candidate not acceptable to the Board would by then be bound largely to have lost confidence in the chairman. Mr Philip Jones agreed and added that in practice, problems were rarely encountered in this field. If a good rapport existed between Chairman and Minister problems could usually be avoided.

6 The Chief Secretary said that the formal guidance issued by the Government had to take account of the fact that there might be circumstances in which that rapport did not exist. But he agreed that the problem was unlikely to arise in practice. In reality,

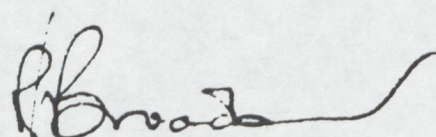
if a difference of opinion arose, the chairman ultimately would have to make clear his views and if necessary consider his position. While the closest possible dialogue with the Chairman was clearly a goal of both Government and the NICG, at the end of the day the formal right of the Secretary of State to make appointments to the Board could not be fettered.

7 In discussion of rolling contracts, the Chief Secretary said he and his colleagues understood the concern of the NICG and had discussed the problems at length. They recognised the need to recruit good executive board members. Their concern about evergreen contract remained that giving indefinite terms of appointment potentially weakened accountability and the possibility of regular reviews of performance. They had concluded that they preferred the alternative of rolling contracts, with regular review dates. These were fairly common in the private sector and had, for example, been adopted by BT on privatisation. It would be necessary to discuss the terms in more detail but he hoped that the idea in concept met the concerns of the NICG.

8 Sir Robert Haslam said he believed a move to rolling contracts would be a step forward. But he found it hard to visualize how a board member would behave if his contract had not been rolled forward while he had up to two years left to serve. He pointed out that it was not the case that performance reviews were not carried out with evergreen contracts. Performance reviews were carried out; it was more the fact that there was no compensation available to nationalised industry board members on loss of office that could lead to some people being on the board for longer than was desirable.

9 In discussion, the Chief Secretary commented that he thought some of the points made by Sir Robert Haslam would apply equally in the case of evergreen contracts. Sir Robert Haslam added that it was not just Ministers that were concerned with the performance of board members; the Chairman was also involved and should be consulted about the performance of individuals. He agreed, however, that the two different approaches boiled down very much to the same thing. It was agreed that more discussion would be needed about the detailed terms involved.

10 At this point the meeting ended and it was agreed to resume discussion at a further meeting to be arranged for the week beginning 3 March.



R J BROADBENT
Private Secretary

Circulation:

Those present
PS/Chancellor
Sir P Middleton
Mr F E R Butler
Mr Byatt
Mr Kemp
Mr Grimstone
Mr Marr
Mr Lord

1987/11

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NOTE OF MEETING HELD IN THE CHIEF SECRETARY'S ROOM ON THURSDAY
6 MARCH AT 5.30 PM

Present:

Chief Secretary
Mr F E R Butler
Mr N Monck
Mr D J L Moore
Mr Grimstone
Mr A M Ellis

Mr P Jones NICG
Sir John Dent NICG
Sir Robert Haslam NICG
Mr J Driscoll NICG

NATIONALISED INDUSTRIES' CHAIRMAN'S GROUP

The meeting resumed the discussions begun on Friday 28 February.

Terms of appointment of Board members

The Chief Secretary said that although, for reasons already discussed, he did not find "evergreen" contracts in the form proposed by the NICG attractive, he was sure that rolling contracts with regular review dates were a considerable step towards meeting the NICG's concerns. A 3-year rolling appointment with regular reviews every 12 months would provide reasonable security of tenure for board members and would alleviate the problem of board members not waiting unduly long to know whether their appointments would be renewed.

Mr Jones welcomed the opportunity to discuss these proposals in further detail. There was, he felt, some misunderstanding of the idea behind "evergreen" contracts. They were in no sense an attempt to obtain greater security of tenure for nationalised industry's boards than existed in the private sector. Rather, they were intended to create realistic terms which reflected the "organic reality" of board membership. Board members regarded membership as a career rather than a short-term posting. A mechanistic system of annual review would corrode that. If board members performed below par then the existence of evergreen contracts would not prevent this

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being dealt with. In addition, under the present arrangements executives promoted to board level had to accept considerable diminution of job security.

Mr Jones suggested that three year rolling contracts would reduce the period of secure tenure from 5 years to 3 years. Annual reviews by the Minister were, he considered, unnecessary as Boards monitored the performance of their members continuously. A two year period of notice of renewal of appointment was not realistic. Boards would not tolerate members working under the cloud of a two year notice period.

It was agreed that the future of rolling contracts had to be considered in the context of provisions for dismissal and compensation and that as the power to pay compensation would require legislation, these issues could not be resolved quickly. Indeed it was not possible to define a basis for ex gratia payments without statutory changes. In this context Mr Jones said that the NICG would like to see the introduction of a statutory requirement that Ministers should explain to Parliament the reasons for dismissal if not for sound business reasons. He accepted however that it would be difficult to define such a provision effectively and that, in the event of controversy, a Minister would inevitably be obliged to explain to the House the circumstances of dismissal.

The Chief Secretary agreed to write to Mr Jones setting out more fully the Government's ideas on appointment procedures.

Pay

Turning to pay, the Chief Secretary said that the Government would continue to be flexible in deciding the salaries of board members, and would pay particular attention to the need to recruit and to retain key individuals. Performance bonuses would be further encouraged provided that they were soundly-based and challenging. He also reported that, in the light of the comments of the NICG on the guidelines on nationalised industry Board membership, Ministers had agreed that they would

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not need to be consulted before a Board initiated a review of pay by consultants. It would nevertheless remain the case that Ministers determined board pay and there was no question of this principle being breached.

Mr Jones and Sir Robert Haslam both expressed considerable concern at this approach. Flexibility and performance bonus schemes were both helpful but they were no substitute for inadequate remuneration, particularly in the absence of the share option schemes which were available to private sector board members. The "recruitment and retention" criteria led to anomalies within the board and to reverse differentials between some board members and senior management. Sir Robert added that he found the differentials between board members recruited from the private sector and those promoted from within particularly difficult to justify. Both the level and the structure of pay had an adverse effect on the morale of internal promotees. It had never been the case that nationalised industries' board members pay levels had attracted public censure and increases would not lead to the public outcry that the TSRB's report had. Sir Robert was particularly concerned that a comprehensive review by Hay/MSL to establish ranges for the members of each board was not acceptable to Ministers. There were, he felt, a number of misconceptions about this system. In particular, it simply provided the basis for a more rational pay structure. It did not preclude the scaling down of pay levels to take account of the industries' public sector status.

The Chief Secretary reiterated that it was the firm view of Ministers that the Hay/MSL approach would be based too much on viewing comparability rather than recruitment and retention and would inevitably lead to claims for large general increases which were incompatible with the Government's pay policy. Both he and his colleagues were convinced that flexibility and performance bonuses were the appropriate route and although he agreed that performance bonuses should be treated with understanding and imagination, the Government would need to ensure they were soundly based. He was unable to go further

in meeting the NICG's concerns.

Future Arrangements

The Chief Secretary agreed with Mr Jones that the work done by officials on the future arrangements for corporations remaining in public ownership ("the Joint Memorandum") had been useful. In the absence of legislation for nationalised industries as a whole, the general thrust of the Memorandum should be embraced and developed as and when specific legislative opportunities arose. Mr Jones thought that there might be some difference between Ministers and chairmen as to the status of the document. Although drafted in some haste, it was essentially an "implementable" document showing the way ahead, to be applied in the context of individual industries. The NICG had commented in some detail on the Memorandum and had expected similar Ministerial comments. He accepted, however, that the means by which the private sector analogy should be extended, in particular in the area of capital reconstruction, did require legislation and to that extent it was difficult to take the discussion further at such a generalized level. It was agreed that the Chief Secretary should write to the NICG explaining the Government's understanding of the Memorandum's status and significance.

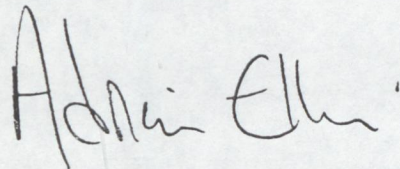
Byatt Report

The Chief Secretary said that Ministerial colleagues were still considering the content of the Byatt report and the timing of its publication and, as he had indicated in his letter to Sir Robert Haslam of 7 February, he would therefore be grateful for the views of the NICG. Mr Jones said that he had been concerned by the Chief Secretary's letter. The NICG needed to discuss the implication of the report with the Government prior to publication and did not feel that publication should be rushed. The report had major ramifications for the nationalised industries: not only could he foresee a number of practical difficulties in implementing it in the context of specific industries; there was also the question of whether

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it was compatible with the move towards closer alignment with private sector practice. Publishing before the NICG had time to reflect on these issues and discuss them would be unhelpful since they would inevitably be asked to give their reactions on publication.

The Chief Secretary emphasised that the report dealt with appropriate accounting principles and not with the detailed implementation of those principles. Its existence was widely known and he was concerned that publication should not be delayed for too long. It was therefore agreed that it would be useful for Treasury officials to meet the Nationalised Industries Finance Panel to establish whether comments would most appropriately be taken on board prior to publication or discussed in the public debate which would follow publication. The Treasury would set in hand the necessary arrangements.



A M ELLIS

cc PS/Chancellor
PS/Chief Secretary
PS/Sir Peter Middleton
Mr F E R Butler
Mr Monck
Mr Byatt
Mr D J L Moore
Mr Kemp
Mr Grimstone
Mr ~~Marr~~ *reid 18/3*
Mr Lord

Nationalised Industries' Chairmen's Group

Chairman
T. Philip Jones, C.B.

Hobart House
Grosvenor Place
London SW1X 7AE
01-235 2020

The Rt. Hon. John MacGregor, MP,
Chief Secretary to the Treasury
Treasury Chambers,
Parliament Street,
LONDON,
SW1P 3AG

CHIEF SECRETARY TO THE TREASURY	
25 MAR	
T	Mr Grimstone
C	CX Sir Peter Middle

24th March, 1986

De-John,

*Mr Butler Mr Monck
Mr Byatt Mr Kemp
Mr Moore Mr Mann
Mr A Ellis Mr Lord*

1st

At the NICG meeting on Friday, 14th March I reported to my colleagues on the outcome of our meetings of 28th February and 6th March.

On three of the four issues which were discussed, we are, of course, still awaiting further developments, (viz. the Joint Memorandum and Board Appointments, on each of which you promised a further letter, and the Byatt Report, where Jim Driscoll has just written to Nick Monck about arrangements for the discussions which you agreed).

As regards Board salaries, I said when we met that I was very disappointed by the Government's response to our proposals. I am bound to tell you that "disappointed" was too mild a comment in the light of my colleagues' reaction. They feel very strongly indeed on this issue and believe that Board Members are being treated in a most unfair and inequitable manner. Chairmen will, of course, do what they can along the "flexibility" line and they will look closely at the scope for performance-related bonus schemes, but these two approaches will not be sufficient to narrow the gap between private sector and public sector salaries, and the performance-related bonus schemes are not an adequate substitute for the right basic pay for the job. The gap which exists between public and private sector Board salaries is untenable both in logic and in equity. It now seems certain to grow even worse. We shall therefore continue to press that Board Members should be properly remunerated.

*Yours
Philip Jones*

Nationalised Industries' Chairmen's Group

Chairman
T. Philip Jones, C.B.

Hobart House
Grosvenor Place
London SW1X 7AE
01-235 2020

27th March 1986

The Rt. Hon. John MacGregor, MP,
Chief Secretary to the Treasury
Treasury Chambers,
Parliament Street,
LONDON,
SW1P 3AG

CHIEF SECRETARY	
REC	- 2 APR 1986
<i>Mr Moore.</i>	
<i>CX PST MST EST.</i>	
<i>Sir Peter Middled</i>	
<i>Mr Butler Mr Mond</i>	
<i>Mr Byatt Mr Grimshaw</i>	

Mr Hobson
Mr Colman
Mr A. Ellis
Mr Lord 1st

Dear John,

I know that you will be as distressed as I am at the recent reports in the "Guardian" and "Financial Times" suggesting that a great row was looming between the Nationalised Industries and the Treasury over the Byatt Report. I do not know where these stories came from. They certainly did not emanate from me, anybody in the Electricity Council or in NICG.

We are, as you know, concerned about the Byatt Report, but it is certainly my wish that any discussions between us are conducted in a civilised manner and not through the columns of the press.

*Yours
M. D.*



FBI
MST
EST
Sir P. Middleton
Mr Butler
Mr A. Wilson
Mr Byatt
Mr Moore

Mr Houston
Mr Robson
Mr Hyman
Mr A. Ellis
Mr Monk.

Treasury Chambers, Parliament Street, SW1P 3AG

T Philip Jones, Esq CB
Chairman
Nationalised Industries' Chairmen's Group
Hobart House
Grosvenor Place
London
SW1X 7AE

3rd April 1986

Dear Philip,

Thank you for your letter of 24 March. I note what you say about the strength of your colleagues' feelings about Board salaries. I will not repeat the points that I made at our meeting but no doubt we will return to this subject after an interval. We shall then have some further experience of the progress - which you say Chairmen argue can be made - by way of flexibility and performance-related bonus schemes.

You mentioned the Byatt Report. I have now seen your letter of 27 March. I agree that it is unfortunate that reports of disagreement on the content of the Report have appeared in the press and I am grateful for your assurances.

As far as handling the Report is concerned, I must say that I was surprised to hear that the Chairmen's Group had decided that the meeting between my officials and your Finance Panel, which we agreed on, should be postponed until after your Group meets on 9 May - three months after I sent your predecessor a copy of Volume I of the Report. (Volume II contains supporting material only and copies of this are being sent to Jim Driscoll).

It would be helpful if an exploratory meeting between officials and the Finance Panel could go ahead in the early part of April, as I understand had been arranged. This should be helpful to the NICG as well as to us. But if

that is not possible, I think we should plan on publication soon after your Chairmen's Group meeting. The Byatt Report, designed to be an advisory report to the Treasury, and its text is of course now settled. You recognised when we met that the Report would have to be published. The Report proposes that the next step should be discussions with the industries. So I do not think that any long drawn out process of consultation beyond what I had in mind at our meeting is needed before publication. I have already invited any comments you might have about what should be said at the time of publication. You may find it useful in that context to see the attached preface to the Report. I shall be considering further what I might say in the House when the report is published.

I am writing separately on the Joint Memorandum and Board appointments.

*Yours sincerely,
John MacGregor*

JOHN MacGREGOR

DRAFT PREFACE TO BYATT REPORT

This Report was commissioned by HM Treasury. It provides advice on ways of developing accounting policies so that accounts of nationalised industries could provide appropriate measures of economic cost. It was prepared by a Group whose members came from outside the Treasury, except for the Chairman, and served in a personal capacity.

2. The Report is likely to be of interest to all those in the accounting profession and elsewhere, as well as in the nationalised industries, who are concerned with accounting for economic costs and changing prices. It is being published as a contribution to this wider debate.

3. The Treasury, in association with the sponsor Departments, will now be discussing the general principles described in the Report with the individual nationalised industries.

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MST
EST
Sir P. Middleton
Mr Butler
Mr A. Wilson
Mr Byatt
Mr Moore

Mr Houston
Mr Robson
Mr Hyman
Mr A. Ellis
Mr Monck

Handwritten initials

Treasury Chambers, Parliament Street, SW1P 3AG

T P Jones Esq CB
Chairman of the Nationalised Industries' Chairmen's Group
and Chairman of the Electricity Council
30 Millbank
London
SW1P 4RD

3rd April 1986

Dear Philip,

NATIONALISED INDUSTRIES' CHAIRMEN'S GROUP

At our meeting on 6 March I said that I would write to you to set out where we now stood on questions about the relationship between the Government and the Nationalised Industries which were discussed last year in preparation for the proposed Bill. I am writing to you separately about appointments.

When I announced on 15 November that the Government had decided not to proceed with general legislation on the nationalised industries in this Parliament, I said that the Government intended to continue to strengthen the industries to the point where they can either be transferred to the private sector, or where necessary, remain as successful businesses within the public sector. That remains our aim. My wording was close to paragraph 2 of the joint memorandum by officials which described the central objective of the proposed legislation.

To recap on the discussions of last year, a number of ideas for those industries remaining in the public sector were examined following the Consultation Document of December 1984. Treasury and NICG officials prepared a joint memorandum, of 29 March 1985, on the common ground established in these discussions and on a way forward. The NICG commented on this in their note of 21 May. You had some discussions with my predecessor but these were not concluded because of the decision not to go ahead with

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the general Bill. As I said in my statement on 15 November, it was agreed that the progress made would be borne closely in mind if further legislative proposals for individual industries were brought forward.

We can look at your comments in your note of 21 May under two heads: the general approach to the relationship between Government and the industries; and your more detailed comments on capital structure and related financial matters.

The General Relationship

In paragraph 3 of your note you argue that the aim should be to base the relationship between Government and the Nationalised Industries as far as possible on that between the Board of a large private sector company and its major institutional shareholders - the "private sector analogy".

As you know from discussions with my predecessor and with me, we have reservations on how far this analogy can usefully be applied. You acknowledge that there are limits to it, though we might not agree on exactly where those limits are. As was noted in the joint memorandum, as long as industries remain in the public sector it is necessary to ensure that the arrangements meet the needs of public accountability and the special circumstances of the nationalised industries. These include Ministers' statutory responsibilities for the industries, their accountability for the exercise of those powers; and the particular responsibilities they have to Parliament; the fact that the Government is regarded as standing behind the industries financially, and that some industries are not profitable; the degree of monopoly power which some of the industries have; the need to protect consumers; and the need to ensure that resources within the public sector generally are used efficiently and earn an adequate rate of return in comparison with that earned in the private sector.

For these reasons, I see the private sector analogy as offering not a general prescription but a useful basis for questioning and analysing our approach to some particular issues and to seeing where improvements might be made.

For example, we are currently looking at ways to improve the arrangements for Board appointments. We agree with you that, subject to amendments of the present statutory powers, there is scope for bringing the arrangements for appointments to Boards more closely in line with those in the private sector.

There are other issues where the private sector analogy is not necessarily relevant, let alone conclusive. For example, investigations by the Monopolies and Mergers Commission into the industries are an important part of the arrangements for public accountability. We need to

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satisfy Parliament and ourselves that these arrangements are sound and to improve them where necessary. Similarly, irrespective of decisions taken by private sector companies on the form of their accounts, there are good reasons for continuing to have available price-level adjusted information for nationalised industries, and we would not necessarily accept that this question can be settled by the simple application of the private sector analogy.

My conclusion is that we need to look at general questions of this sort one by one. I fully agree that it is often instructive and stimulating to look at what is private sector practice and whether that points to improvements which we can make in the arrangements for the nationalised industries. This seems to me a practical approach which recognises that the private sector analogy can be useful but is not necessarily relevant to all the issues we have to consider.

In addition to general questions applicable to all the industries, there will of course continue to be many questions on particular industries and their relations with Government which can best be pursued by those industries and their own sponsor Departments.

Subject to the general framework of controls and to the agreed objectives for individual industries, we want Boards and managements to be free to use their skills and initiative to continue to improve the performance of their industries and to make them vigorous, efficient and successful businesses.

Capital Structure and Related Financial Questions

Following the decision not to go ahead with the general Bill we agreed that discussion of these questions could best be taken forward by analysis of the possibilities for a particular industry, such as the Post Office. This seems to us the most practical way of testing out the ideas and developing them.

... In the meantime I attach a note by Treasury officials which records some comments on the points made on this section of the NICG's note of 21 May. I must emphasise that these, like the joint memorandum, are Treasury, rather than interdepartmentally agreed, views but I hope that they will help in indicating what would be our initial approach in any discussion between an individual industry, its sponsor Department and the Treasury.

Yours sincerely,

John Macgregor

JOHN MacGREGOR

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Comments by Treasury Officials on the Sections on Financial Controls in the NICG's Note of 21 May 1985

Capital Structure

1. It was agreed in the joint memorandum of 29 March 1985 by Treasury and NICG officials that it would be for each Board to put forward their proposals for any capital reconstruction although, if necessary, Ministers could set the process moving by inviting them to do so. It is fully accepted that in any particular capital reconstruction the mix of State-owned public equity capital, loan capital, and reserves must be appropriate to the circumstances of that industry.

2. It was agreed that additional debt would be created from reserves only with the specific agreement of the appropriate Board and in order to provide a suitable gearing. We note that the NICG are not yet convinced that it would be equitable to create debt in this way. On the other hand, it would be consistent with the wish to move closer to the capital structure of a private sector company for a Board to have some substantial amount of debt within the capital structure of their industry. That some industries are now nearly free of debt is partly a reflection of the fact that over the years their capital structure has not been amended to take account of inflation, and their improving performance and financial results. If they had had a capital structure closer to that of a successful private sector company they would have been paying dividends, in some cases substantial, and some of their debt would have been renewed rather than paid off. For these reasons we hope that individual industries considering capital reconstruction will not rule out the possibility of creating some debt from reserves. We agree with the NICG's point, in paragraph 7(b) of their note of 21 May, that it would be relevant to look at the gearing of a broadly similar private sector company.

Targets, Dividend Policy & Reserves

3. Private sector companies are subject to a variety of financial disciplines which stimulate them to operate efficiently and earn an adequate return on their capital. For many years now the approach to the nationalised industries has been to apply disciplines, primarily through External Finance Limits (EFLs), investment allocation and financial and performance targets, which are broadly similar in effect to those in the private sector. Capital restructuring, and dividend targets, could help to reinforce those disciplines.

4. This is in line with the PAC's thinking, particularly for those industries generating surplus cash. In the Twentieth Report of 1979-80, it concluded that:

"there should not be a strong presumption that surpluses in excess of interest commitments should all be retained by an industry".

It thought that:

"an industry should not be allowed to amass reserves to such an extent that there is a danger of blunting the edge of the discipline that should operate on future investment decisions".

In its Fifteenth Report of 1980-81 the PAC concluded that the creation and maintenance of a suitable capital structure had an important role in promoting financial discipline. It recommended that the creation of liabilities to pay to the Exchequer out of surpluses "a pre-determined sum related to the target set could be seen as equivalent to servicing the publicly-owned 'equity' in the industries; and payments required in this way should be less of a disincentive to the management than clawback arrangements".

5. We agree with the PAC's conclusions. While they are related primarily to cash surplus (i.e. negative EFL) industries, we believe that they are also relevant to profitable nationalised industries which are not fully self-financing. Against this background, our general approach to targets, to dividends, and to reserves is as follows.

6. The present arrangements for EFLs, investment allocations, medium-term financial and performance targets will continue. Even where capital reconstructions are made, such targets will still be necessary for public sector industries not subject to the discipline of a quoted share price and the threat of takeover, and in some cases not facing the full forces of competition.

7. Dividend targets cannot be set in a vacuum and, before deciding on them, it will first be necessary to reach agreement on the targets for return on capital employed, and for cost reductions. These financial and performance targets should then be announced. In part this is necessary to enable Ministers and Boards to explain and defend the dividend target, and the disciplines applying to the industry, to Parliament and to the public. Moreover, without a published financial target, an industry could fail to earn the required return on capital but still meet its dividend target by drawing on prior year reserves. So, although they might in future be given greater emphasis in public statements than financial targets, it is not sufficient to rely on dividend targets alone. Provided they were consistent with financial and performance targets we do not think that the NICG need fear that "double targetry" would be a serious problem.

8. For industries with surplus cash (i.e. under present terminology, negative EFLs) we would normally expect interest plus dividends plus tax to bring all of the pre-tax profit back to the Government. In line with the PAC's conclusions, we would not expect the industries to build up big cash reserves for possible use in the distant future. But we recognise

that, subject to the usual assessment and approval of investment, industries might want to put some cash on deposit in a capital investment reserve when they expected to move in the near future - say, within the 3 years of the target period - to a position where they were less than 100 per cent self-financing. It would also be necessary to consider the arrangements for any industry with cash surpluses more than could appropriately be paid to the Government as dividends. This might be dealt with by paying off existing debt. Or if there were to be a long-term decline in capital employed by an industry there might be a case for considering a capital distribution. In practice these questions would need to be discussed in detail for each industry and with regard to its particular financial circumstances and prospects.

9. The approach would be similar for profitable industries which were not self-financing (i.e. with positive EFLs). Where such an industry had equity we would expect dividends to provide an adequate real return notwithstanding the industry's need to borrow to meet its financing requirements.

EFLs

10. Whatever changes are made in capital structures and in the form of payments, the industries' dividends, deposits and net borrowing will continue to have a direct impact on the Public Sector Borrowing Requirement. It follows that we must continue to take a close interest in these cash flows both in individual years and cumulatively over a period.

11. This is why we want to ensure that the dividends, derived from the 3-year financial targets, are indeed delivered over the 3-year period with any unavoidable shortfall in one year picked up and offset later. In this sense the dividends would be cumulative; though, provided the point of substance is accepted, we agree with the NICG that it is not necessary to use the term "preference share".

12. When new arrangements were introduced we could look again for some better terminology than "negative EFLs", provided that it is understood that the totals and sub-totals of the outturn and the estimated cash inflows to, and outflows from, the Government will be published as now. An important difference will be that for the most part, and perhaps entirely, these inflows will have the more familiar labels of interest and dividends. This may help to make it more readily accepted that there is nothing wrong with successful nationalised industries making such payments to the Government and, moreover, that these payments are in no sense a tax on the consumer.

13. There will be times when industries earn returns higher than was assumed when the target was set. But subject to that we reaffirm that there is no intention of using these new arrangements to raise tax revenues by some additional impost over and above the requirements of the financial and dividend targets. We accept the NICG's point that if exceptionally Ministers were to decide to make such an impost it would be right to seek separate statutory backing, as for the gas levy.



CXC
 FST
 EST
 MST
 Sir P. Middleton
 Mr Butler
 Mr Kemp
 Mr Marek
 Mr Moore
 Mr Coleman
 Mr Rakson
 Mr Bristow
 Mr Marr
 Mr Lord
 Mr Byett - T. Sol.
 Mr Grimstone.

Treasury Chambers, Parliament Street, SW1P 3AG

Philip Jones Esq CB
 Chairman
 Nationalised Industries' Chairmen's Group
 30 Millbank
 London
 SW1P 4RD

4m
 4 April 1986

Dear Philip,

**NATIONALISED INDUSTRY BOARD MEMBERS:
TERMS OF APPOINTMENT**

I promised that I would write to you and set out our proposals to improve the present terms of appointments for board members. You have already let us have your ideas ... and I enclose a note which responds in detail to the suggestions that you put to us last year. It follows discussions that I have held with the other Ministers concerned.

As you know, the two main areas where we would like to make progress are rolling-term appointments and dismissal arrangements linked to compensation. Our ability to move forward quickly is however constrained by statutory provisions. For example, instruments of appointment for NCB and Electricity (GB) board members, unlike other industries, must be for a fixed term and cannot include dismissal provisions. The only industry where we can promise in advance to pay compensation to a dismissed board member is LRT. If we had proceeded with general nationalised industry legislation, we would have removed present statutory restrictions and effectively allowed individual terms of appointment to be freely negotiated against the background of whatever non-statutory guidelines seemed appropriate. This would have greatly enhanced flexibility.

The approach that we would like to adopt for rolling-term appointments is set out in the enclosed note and we think that it strikes the right balance between accountability and job security. I acknowledge the importance that you rightly attach to a Chairman's view in these matters and I would envisage the annual review (if that is the period which is adopted) being a joint

matter for the Chairman and the Secretary of State, though with the decisions resting with the Secretary of State.

Although for industries other than LRT, we are not able under existing legislation to give enforceable advance assurances about compensation we have recently been advised that we could give guidance as to how we would expect generally to apply compensation arrangements. For example, we could indicate that when deciding whether special circumstances existed that warranted compensation being payable when a member left office, Ministers would generally take into account the circumstances which caused the appointment to be terminated, including whether the termination was at the instigation of the Secretary of State. The method of calculating any such compensation could also be described. Although this necessarily falls short of an absolute assurance, I would hope that it might provide sufficient comfort to allow dismissal and compensation provisions to be negotiated for some future instruments of appointments in advance of legislative change.

The whole area of terms of appointment is extremely complex, and once the NICG has considered our proposals, the best way forward might be for our officials to have detailed discussions about practicalities. We all agree that it is an important topic if we are to recruit, retain, and motivate good-quality board members and I think that we should make improvements if we can.

Yours sincerely,
John MacGregor

JOHN MacGREGOR

TERMS OF APPOINTMENT OF NATIONALISED INDUSTRY BOARD MEMBERS

Commentary on NICG proposals

1. Selection and Appointment of Chairmen

NICG Proposal

The power to select and appoint Chairmen should remain wholly for the Secretary of State.

Commentary

This represents present practice and it is agreed that this should continue.

2. Selection and Appointment of Board Members

NICG Proposal

Although appointments would formally be for the Secretary of State, the task of searching out and proposing potential members should generally be the responsibility of the Chairman concerned.

Commentary

It is already the usual practice for a Secretary of State to consult the Chairman before appointing new Board members and it is always open to a Chairman to propose an internal candidate (in the case of Executive Members) or the recruitment of an outsider. However, while the Chairman concerned should always be closely involved in appointments to his Board, the prime responsibility for making them must

lie with the Secretary of State. To make Chairmen formally responsible for searching out and proposing potential members would detract from this. The Government is not able therefore to accept the NICG's proposal but it would expect sponsor Ministers to keep in close touch with a Chairman when selecting board members.

3. Nature of Appointments

NICG Proposal

Executive board members should be given "evergreen" contracts "automatically extended from day to day". The normal term of such contracts should be three years although the Secretary of State might extend this for particular industries. Board members would thus always have, until retirement, 3 year security of tenure or a corresponding right to compensation. Non-executive board members should have fixed term appointments, normally for three years.

Commentary

The arrangements proposed by the NICG for executive board members would run-on indefinitely unless positive steps were taken to terminate an appointment. The Government considers that this would detract from accountability and that all board appointments need to be regularly reviewed. For example, directors of private sector companies generally have to offer themselves for periodic re-election.

The form of rolling contract in use in British Telecom provides for appointments to be renewed annually. The Government sees some attraction in adopting this procedure and providing for fixed-term appointments of executive board members to be reviewed each year by the Secretary of State in consultation with the Chairman. At each review, the option would be either to roll-on the appointments original period by a further twelve months or to decide that the appointment would expire at the end of its original fixed

term period. In most cases the appointment would no doubt be extended. Such a procedure would mean that board members whose appointments were not to be extended beyond the end of their original period would be given much greater notice than has sometimes been customary in the past and this is clearly desirable. Details of appointments made on these terms would of course need to be negotiated between the Secretary of State and the prospective board member at the time of appointment. The Government's present view is that 3-year appointments with 12-monthly reviews might represent best practice. The Government accepts that non-executive board members should have fixed term appointments.

4. Written Statement of Terms and Conditions of Appointment

NICG Proposal

Individual board members should have an adequate written account of the terms and conditions on which they hold office.

Commentary

The Government accepts that this is desirable and it is generally done already. A general guidance note for board members has recently been produced.

5. Power to Dismiss Chairmen
Power to terminate contracts

NICG Proposal

Provided that overall legislation moves industries closer to the position of large private sector companies, the Secretary of State should, as the ultimate discipline, have a power to dismiss a Chairman for sound business reasons (but not for "what are perceived to be political shortcomings") with an explanation given to Parliament unless the Chairman concerned requests otherwise. Compensation would be payable.

The Secretary of State would have power to terminate the contract of any executive board member, with proper compensation, provided the Chairman had made a formal recommendation to that effect.

Commentary

Existing statutes, other than those for the NCB and the Electricity Supply Industry (GB), already allow instruments of appointment to contain dismissal provisions but this power has not generally been utilised. Ministers do consider that powers should be available that allow board members to be dismissed but they do not intend to incorporate dismissal provisions in instruments of appointment until, following legislation, this can be linked to guaranteed compensation, or it is agreed that the arrangements discussed in paragraph 4 of the covering letter are acceptable

At present, only London Regional Transport statutes allow compensation to be promised in advance and legislation would be needed to extend this to other industries.

The Government does not consider that it would be appropriate formally to fetter Ministers' powers to dismiss executive board members or Chairmen. But, in practice, a Minister would expect to consult a Chairman before dismissing an executive board member, where the proposal to dismiss had not come from the Chairman.

Likewise, Ministers would not consider it appropriate to be bound by statute invariably to explain to Parliament their exercise of a dismissal provision although in practice, of course, it is open to Parliament to request an explanation if a Minister had not volunteered it.

6. Declaring Offices Vacant

NICG Proposal

Present powers should continue. The NICG would not object to some standardisation but see little advantage to be gained from it.

Commentary

The Government agrees with the NICG's comments. Any standardisation of existing powers would require legislation.

7. Resignations

NICG Proposal

Any board member may resign by giving six months notice or such shorter period as the Secretary of State after consultation with the Chairman agrees.

Commentary

The Government accepts this proposal but present periods of notice set out in statutes vary and standardisation would require legislation.

8. Compensation

NICG Proposal

In determining compensation, "good private sector practice" should be followed.

Commentary

Existing statutes other than LRT do not allow advance assurances of compensation to be made in instruments of appointment. When compensation payments are made under existing arrangements (eg on an ex gratia basis), the Government's standard practice across the public sector is to follow the common law approach (which includes an offset on account of estimated income likely to be gained from alternative employment). There does not seem to be a case for treating nationalised industries differently.