



cc: Chancellor

FST

EST

MST

Sir P Middleton

Mr Bailey

Mr Monck

Treasury Chambers, Parliament Street, SW1P 3AG

Mr Burgner

Mr Scholar

Mr Gray

Mr Webb

Mr Robson

Mr Bird

Ms Leahy

Rt Hon Peter Walker MBE MP
 Secretary of State for Energy
 Department of Energy
 Thames House South
 Millbank
 London
 SW1P 4QJ

18 September 1984

**NATIONALISED INDUSTRIES BILATERAL:
 24 SEPTEMBER 1984**

We are meeting on 24 September to discuss your nationalised industry programmes as part of the 1984 Investment and Financing Review. In preparation for this, I attach tables which set out the present financing bids received from each of your industries and I hope that we can use these as a common starting point for our discussions.

2 We agreed at E(A) on 3 July that we should reduce industries' aggregate bids to £250 million below the baseline in 1985-86, £500 million below in 1986-87, and £1,000 million below in 1987-88. These are demanding targets but it is essential that we meet them if our overall objectives are to be achieved. We have to recognise that some industries will be able to contribute more to this target than others. At E(A) the Prime Minister said that all sponsor Ministers will need to do their utmost to secure satisfactory reductions.

3 E(A) also agreed some general guidelines for our discussions and I shall want to consider for each of your industries the scope for:-

- (i) reducing current costs and improving profitability
- (ii) reducing working capital
- (iii) cutting investment
- (iv) selling fixed assets

4 Clearly the present coal strike creates uncertainty. I recognise that we may well have to look at the NCB (and possibly Electricity) figures again when it is over. At that time we shall obviously need revised projections from Ian MacGregor quickly. In the meantime, I suggest we assume for present purposes that the strike has no effect beyond 1984-85. This is admittedly artificial but I can see no other sensible basis for our discussion. My proposals for the NCB are in a separate Annex to this letter as this may be helpful for circulation. We will need to ensure that the figures (eg on coal deliveries) remain on a consistent basis between the industries.

5 Turning to the figures, I will be seeking reductions from the baseline for external finance for your industries of the order of £400 million in 1985-86, £600 million in 1986-87 and £1 billion in 1987-88. Against these we have to set the increases assumed for the Redundant Mineworkers Payment Scheme of £115 million in 1985-86, £15 million in 1986-87 and £22 million in 1987-88. Clearly I would be very ready to be guided by you about the way this is spread between your industries and about the form which the savings take. You might find it useful to know my thinking on these points and this is set out in the rest of this letter. You will note that the suggestions on individual industries total more than the aggregates I am seeking from you.

A Electricity Supply Industry (England and Wales)

6 The revised bids compared to baseline are (£m):-

1985-86	1986-87	1987-88
+ 24	+ 298	+ 570

We need to settle both the ESI's external financing requirements and its next financial target and performance aim from 1985 - 86.

7 Nigel Lawson wrote to you on 2 August and 13 September explaining our view that the next target should be based on a 5 per cent return on current cost assets. Our officials have also been exploring the scope for cost savings.

8 I suggest we consider a longer target period than the three years the industry have in mind, perhaps five years. That would give greater stability and, by running into the next Parliament, avoid any awkward hiatus just before the end of this one.

9 Five per cent targets are already in place on the Industry's appliance retailing and contracting activities. It appears to be common ground with the ESI already that, for transmission and distribution, charges should be based on a 5 per cent return. That leaves the generation assets (some 60 per cent of the total). Here I am prepared to see a gradual transition over the period to 1987-88. By then the new power stations currently under construction and the cross-channel link are due to be completed. Our assessment is that, with a determined drive to get full use from this investment and to reduce costs elsewhere, a 5 per cent return could be achievable without real price increases. This should be enshrined in a demanding performance aim.

10 Accordingly, I propose a target from 1985-86 to 1988-89 based on:-

- (a) A return on generating assets rising linearly to 5 per cent by 1987-88, remaining at that level thereafter.
- (b) An average return on non-generating assets of 5 per cent. This would give an overall figure of about 4.5 per cent for a five year period

Allowing for Corporation Tax and other adjustments, external financing requirements should be reduced by some:-

	1985-86	1986-87	£m 1987-88
Higher financial target	- 250	- 400	- 700

11 I am assuming that future arrangements for load management do not affect the financial target.

12 In order to achieve the E(A) target we need also to look for other savings. I suggest we look for reductions (net of Corporation Tax) of the following order:-

	1985-86	1986-87	£m 1987-88
Other savings	- 175	- 375	- 450

May we discuss the following areas:

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- (a) Capital investment where reductions could come principally from a prudent view of when Sizewell B might proceed; deferring refurbishment of the transmission and distribution system; leaving small generating projects (wind, hydro etc) to the private sector; reduced provision for development projects (eg oil to coal conversions); real reductions in the cost and volume of new connections by the later years
- (b) Working capital mainly from running down nuclear stock holdings more quickly; and a lower coal and oil price assumption.
- (c) Accelerating the sale of fixed assets
- (d) Recovering the cost of new connections up to the statutory limits (and again without changing the financial target).
- (e) Interest, resulting from other reductions.

13 We also have doubts about the economic viability of some non-operational investment by Area Boards, where there has been substantial growth in bids since last year; the Industry have not yet convinced us that these Boards' programmes will earn the Required Rate of Return. Normally I should have looked for further reductions of some £40 million a year here. But if the Boards can reassure us - by accepting the 5 per cent target - I will not need to pursue this.

14 Overall these savings would give external financing figures compared to baseline of:-

	1985-86	1986-87	1987-88
Reductions compared to baseline	- 401	- 477	-580

B British Gas Corporation

15 The original bids compared to baseline are (£m)

	1985-86	1986-87	1987-88
	+ 75	+ 237	+ 389

The Wytch Farm disposal gives rise to an additional £84 million in 1985-86 in respect of corporation tax.

16 BGC are forecasting substantial peak day physical surpluses of gas towards the end of the IFR period. This has substantial EFL implications and reducing the physical surpluses would produce corresponding savings - for example by postponing the second phase of the Morecombe project, by delaying filling the Rough reservoir and by contracting for less peak supply gas. These savings could build up to £115 million by 1987-88.

17 The Corporation's investment in research into substitute natural gas (SNG) is also proving expensive. Sir Denis Rooke himself has said that the country will not need to depend on SNG much before 2050. I suggest the research programme should be terminated. This would save £40 million a year by 1987-88.

18 I would like to discuss the prospect of increased sales of BGC's surplusland.

19 In addition to these savings, I should also like to discuss with you:-

- (a) capital investment - further reductions, particularly on exploration but also on onshore investment
- (b) working capital - reductions in stocks (other than gas) and some further pressure on debtors
- (c) trading costs - further reductions in trading costs, both as a result of not filling Rough and through continuing pressure on manpower.

Overall, I think we could achieve savings (after tax) in these areas of

1985-86	1986-87	1987-88	(£ million)
- 70	- 150	- 260	

20 On gas prices, you know my view, shared by the Chancellor, that gas is still substantially underpriced in both domestic and non-domestic markets. Our officials have together been looking at the figures over recent months and it would appear that BGC is currently undercharging by over 20 per cent in the domestic market and something of a similar order in other markets. BGC's tariff proposals over the IFR period do nothing to rectify this. Indeed, the gap widens by 1987-88. In my view, we must seek to close the gap. A 4 per cent real price rise each year for 3 years from 1 January 1985 would go a long way towards achieving this. After tax, and taking account of working capital effects, this would generate savings of around:-

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- 220 - 440 - 774

21 Overall these savings would amount to a reduction compared with BGC's initial bid of:-

- 290 - 590 - 1,034

After taking account of BGC's extra tax liability for the Wytch Farm sale, the reduction compared with baseline would be :-

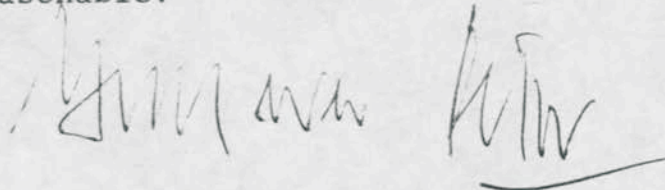
- 131 - 353 - 645

C. BNO

22 The bids compared to baseline are (£m):

1985-86	1986-87	1987-88
+ 1.2	- 0.4	- 0.1

23 I appreciate that a measure of uncertainty surrounds BNO's finances over the IFR period. It would be very helpful if you could bring the Corporation back to baseline in 1985-86. I believe that the corporation's current losses should reduce the corporation tax payment they were anticipating in 1985-86. This means a return to baseline in that year is reasonable.



PETER REES

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NCB

1. The figures including RMPS are compared to baseline:

£m

	1985-86	1986-87	1987-88
Bid for external financing (i)	+172	+326	+80
Bid for additional RMPS	+115	+ 15	+22
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	+287	+341	+102

(i) Adjusted for effect of full use of French interconnector
The strike clearly creates major uncertainties, particularly for internal resources and stock provision. Nonetheless certain areas for savings can be identified elsewhere, consistent with established policy:

(a) Investment in fixed assets

	1985-86	1986-87	1987-88
Baseline	784	748	767
Bid	+25	+39	+7
Saving	-75	-53	-40

This reduction simply reduces the provision for the four years (1984-85 to 1987-88, including £798m this year) down to a total of £3000m. Further reassessment will be needed later.

(b) Sales of assets

Saving	-20	-20	-40
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Given NCB's dire financial circumstances, acceleration of the sale of non-mining subsidiaries and other assets is needed.

(c) Working capital General squeeze and elimination of contingencies.

	1985-86	1986-87	1987-88
Savings	-10	-30	-30

(d) Assume break-even by 1987-88 as in Mr McGregor's objectives

	0	0	-40
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These will give total reduction compared to base of:

	-105	-103	-150
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and changes compared with baseline of:

NCB	+67	+223	- 70
RMB	+115	+ 15	+ 22

UNREVISED BID

Industry : NATIONAL COAL BOARD

BASELINE £ million	1984-85 forecast outturn	1985-86	1986-87	1987-88
Fixed asset investment	598	784	748	767
TOTAL CAPITAL REQUIREMENTS	322	640	600	615
TOTAL INTERNAL RESOURCES	-1,278	-83	218	223
TOTAL EXTERNAL FINANCE	1,600	723	382	392

PROPOSED CHANGES COMPARED TO BASELINE £ million	1985-86	1986-87	1987-88
Fixed assets in UK	+25	+39	+7
Working-capital	+39	+64	+40
Other	-	-1	-
TOTAL CAPITAL REQUIREMENT CHANGE	+64	+102	+47
EXPECTED CHANGE IN INTERNAL RESOURCES	-108	-224	-33
Grants	+93	+164	-18
PDC	-	-	-
Net temporary borrowing	-7	-7	-7
Net long and medium term borrowing	+81	+162	+96
Leasing	+5	+7	+9
TOTAL PROPOSED CHANGE IN EXTERNAL FINANCE	+172	+326	+80

ASSUMPTIONS % CHANGE	1984-85	1985-86	1986-87	1987-88
GDP	1.5	1.5	1.5	1.5
Retail Price Index	6.0	6.0	6.0	6.0
Average earnings (whole economy)	-	-	-	-
Average earnings (own industry)	4.0	4.5	5.0	5.0
Tariffs (overall)	2.0	5.0	5.5	6.0
Tariffs (domestic)	4.0	5.0	6.0	6.0
Tariffs (industrial)	2.5	5.0	5.0	5.5
Manpower (no)	220,800	199,700	185,700	176,100

REVISED BID

Industry : ELECTRICITY (ENGLAND AND WALES)

BASELINE £ million	1984-85 forecast outturn	1985-86	1986-87	1987-88
Fixed asset investment	1,321	1,195	1,095	1,123
TOTAL CAPITAL REQUIREMENTS	1,056	1,125	990	1,015
TOTAL INTERNAL RESOURCES	1,936	2,147	2,327	2,385
TOTAL EXTERNAL FINANCE	-880	-1,022	-1,337	-1,370

PROPOSED CHANGES COMPARED TO BASELINE £ million	1985-86	1986-87	1987-88
Fixed assets in UK	+23	+133	+75
Working-capital	+47	+55	+97
Other	-	+6	+24
TOTAL CAPITAL REQUIREMENT CHANGE	+70	+194	+196
EXPECTED CHANGE IN INTERNAL RESOURCES	+46	-104	-374
Grants	-	-	-
PDC	-	-	-
Net temporary borrowing	-168	-	-
Net long and medium term borrowing	+233	+343	+616
Leasing	-41	-45	-46
TOTAL PROPOSED CHANGE IN EXTERNAL FINANCE	+24	+298	+570

ASSUMPTIONS % CHANGE	1984-85	1985-86	1986-87	1987-88
GDP	2.7	1.8	1.4	1.4
Retail Price Index	5.0	5.0	5.0	5.0
Average earnings (whole economy)	7.0	6.0	6.0	6.0
Average earnings (own industry)	6.1	5.8	5.8	5.8
Tariffs (overall)	-	-	-	-
Tariffs (domestic)	1.8	3.3	3.5	3.5
Tariffs (industrial)	2.3	3.3	3.5	3.5
Manpower (no)	133,500	130,500	128,100	-

UNREVISED BID ⁽¹⁾

Industry : BRITISH GAS CORPORATION

BASELINE £ million	1984-85 forecast outturn	1985-86	1986-87	1987-88
Fixed asset investment	841	731	811	831
TOTAL CAPITAL REQUIREMENTS	1,060	912	1,051	1,078
TOTAL INTERNAL RESOURCES	1,248	1,308	1,546	1,585
TOTAL EXTERNAL FINANCE	-188	-396	-495	-507

PROPOSED CHANGES COMPARED TO BASELINE £ million	1985-86	1986-87	1987-88
Fixed assets in UK	-93	-125	-93
Working-capital	+115	-4	+74
Other	-	-	-
TOTAL CAPITAL REQUIREMENT CHANGE	+22	-129	-19
EXPECTED CHANGE IN INTERNAL RESOURCES	-137	-366	-408
Grants	-	-	-
PDC	+84	-	-
Net temporary borrowing	+75	+237	+389
Net long and medium term borrowing	-	-	-
Leasing	-	-	-
TOTAL PROPOSED CHANGE IN EXTERNAL FINANCE	+159	+237	+389

(1) the original bid has been revised to take account of the corporation tax payment in 1985-86 resulting from the Wytch Farm disposal

ASSUMPTIONS % CHANGE	1984-85	1985-86	1986-87	1987-88
GDP	2.5	1.5	1.0	1.0
Retail Price Index	6.5	8.0	8.0	8.0
Average earnings (whole economy)	8.5	10.0	10.0	10.0
Average earnings (own industry)	6.5	8.0	8.0	8.0
Tariffs (overall)	4.7	6.9	7.8	7.8
Tariffs (domestic)	4.5	6.7	7.9	8.1
Tariffs (industrial)	5.7	7.6	7.8	7.5
Manpower (no)	97,000	95,000	93,000	91,000

UNREVISED BID

Industry : BRITISH NATIONAL OIL CORPORATION

BASELINE £ million	1984-85 forecast outturn	1985-86	1986-87	1987-88
Fixed asset investment	.4	.2	.3	.3
TOTAL CAPITAL REQUIREMENTS	.4	.2	.3	.3
TOTAL INTERNAL RESOURCES	4.4	3.0	2.3	2.4
TOTAL EXTERNAL FINANCE	-4.0	-2.8	-2.0	-2.1

PROPOSED CHANGES COMPARED TO BASELINE £ million	1985-86	1986-87	1987-88
Fixed assets in UK	-	-	-
Working-capital	-	-	-
Other	-	-	-
TOTAL CAPITAL REQUIREMENT CHANGE	-	-	-
EXPECTED CHANGE IN INTERNAL RESOURCES	-1.2	+4	+1
Grants	-	-	-
PDC	-	-	-
Net temporary borrowing	+1.2	-4	-1
Net long and medium term borrowing	-	-	-
Leasing	-	-	-
TOTAL PROPOSED CHANGE IN EXTERNAL FINANCE	+1.2	-4	-1

ASSUMPTIONS % CHANGE	1984-85	1985-86	1986-87	1987-88
GDP	-	-	-	-
Retail Price Inde	6.0	6.0	6.0	6.0
Average earnings (whole economy)	-	-	-	-
Average earnings (own industry)	6.0	6.0	6.0	6.0
Tariffs (overall)	-	-	-	-
Tariffs (domestic)	-	-	-	-
Tariffs (industrial)	-	-	-	-
Manpower (no)	140	140	140	140