CONFIDENTIAL

P.01328

PRIME MINISTER

Nationalised Industries'1984
Investment and Financing Review:
E(A)(84)36

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BACKGROUND

This memorandum by the Chief Secretary, Treasury, with the accompanying note by officials, is the first stage in consideration by Ministers collectively of the investment programmes and financing requirements of the nationalised industries in the context of the public expenditure survey. Its coverage is much the same as last year. The main difference is that London Regional Transport is included for the first time. It is assumed that the warship-building part of British Shipbuilders will be privatised at the end of 1985-86; but the National Bus Company is assumed to be part of the public sector for the whole of the period considered (ie up to the end of 1987-88).

2. The main figures are set out in the Annex to this brief. The industries are bidding for additional external finance of £774 million in 1985-86 and £1313 million in 1986-87. The bid for 1987-88 is nearly £1300 million above the base-line; but in that year the base-line is an arithmetical construction produced by increasing all figures for 1986-87 by 2½ per cent. There are also bids for additional finance for the Redundant Mineworkers' Pension Scheme (RMPS): an additional £115 million is sought in 1985-86, and smaller amounts in later years.

3. There is a small increase in forecast capital requirements for each of the three years: about £360 million in 1985-86, and about £175 million in each of 1986-87 and 1987-88. But the main cause of the increase in external financing requirements is the forecast reduction in internal resources by over £400 million in 1985-86 and over £1100 million in each of 1986-87 and 1987-88.

4. The fall in forecast internal resources is common to most industries; the most notable are the following.

Change in internal resources

£ million

	1985-86	1986-87	1987-88
NCB	- 108	- 224	- 33
Electricity (E & W)	- 116	- 235	- 556
BGC	- 51	- 366	- 408
BSC	- 49	- 194	- 166
BRB	- 23	- 72	+ 7
Total	- 412	- 1138	- 1128

A part of the reductions for some industries (notably electricity and gas) is due to the tax changes in this year's Budget. In the case of Electricity (E & W), the additional Corporation Tax liability due to the Budget is £175 million in 1986-87 and £27 million in 1987-88. In the case of the BGC there is an increased liability due to the Budget of £100 million over the two years 1985-86 and 1986-87.

5. The Chief Secretary points out that if the industries' bids were accepted it would slow down, or even halt, the expected improvement in their external financing and jeopardise the Government's public expenditure plans. In the light of the difficult prospect for public expenditure this year the Chief Secretary proposes that he should seek

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reductions below base-line of £250 million in 1985-86, £500 million in 1986-87, and £1000 million in 1987-88: in other words, cuts in what the industries have bid for of over £1 billion in 1985-86, about £1.8 billion in 1986-87 and about £2.3 billion in 1987-88. This should preferably be done by reducing the current costs; where this is not enough to secure an adequate rate of return on assets prices will have to be increased. There should also be reductions in bids for working capital; investment proposals without clear justification should be cut back; and industries should be pressed to sell assets, especially surplus land.

6. If the Chief Secretary's proposals are approved, officials would hold discussions with the industries; the Chief Secretary would report back in the early Autumn after bilateral discussions with sponsoring Ministers.

MAIN ISSUES

7. It is unlikely that the Sub-Committee will dissent from the proposition that a significant reduction in the total of bids from the industries is necessary: as the Chief Secretary says, many of the figures are no doubt little more than opening bids from the industries. The main issues are:

(i) Is the scale of reductions proposed by the Chief Secretary a reasonable target?

(ii) Are his suggested ways of cutting back the bids - especially so far as they may entail price increases larger that the industries have proposed - acceptable?

Scale of reductions

8. The Chief Secretary's proposals are ambitious. Last year, at a similar stage of the survey, he proposed that the

More is being sought this year from a smaller pot as BT and BA will be out of the nationalised industry family in 1985-86.

target should be a reduction in bids from the industries of about £1 billion a year. His proposal for the first year of the current survey period is of much the same size; but his proposals for years two and three of this survey go a good deal further. As always, there is a balance to be struck. On the one hand, you will probably wish to give the Chief Secretary as much backing as possible in his discussions with sponsoring Ministers. It is also desirable to set demanding external financing limits (EFLs) so as to maximise the pressures for economy. On the other hand, it stores up trouble if public expenditure plans are laid on an unrealistic basis. Nationalised industry EFLs are a less effective form of control than departmental cash limits; and if the base-line eventually agreed is too optimistic it will not hold. There are many uncertainties: in particular, the miners' strike is bound to have serious adverse effects on the finances of the National Coal Board and may have similar effects on others, notably steel. The NCB has bid for nearly £600 million additional external finance over the three years compared with base-line; that could well prove to be an underestimate.

9. It may be that the right course will be to accept the Chief Secretary's proposals as a basis for opening discussions with the industries but to bear in mind, in other parts of the survey, the the proposed savings may not be delivered in full.

Tax changes

10. Some industries have asked for additional external finance in order to cope with the effects of the changes in corporation tax introduced in this year's Budget: the changes have, among other things, substantially brought

forward incidence of tax payments for some industries. Some Ministers may suggest that it would be unreasonable to require the industries to find savings in order to offset these effects. If the industries raise additional external finance to meet their higher tax liabilities there is no overall effect on the public sector borrowing requirement. To refuse to allow them to raise such finance could therefore be argued to be a backdoor way of cutting the PSBR.

Flag A 11. The Chief Secretary 's letter of 29 May (Copy attached) recognises that there is something in this argument, but points out that companies in the private sector would have to cope with the tax changes and might respond by cutting back current costs or reappraising investment programmes. On the other hand, to the extent that the Budget changes simply bring forward liabilities, companies might well decide to respond by additional short-term borrowing to meet what they could reasonably regard as a temporary cash drain. It will no doubt be pointed out that if the Budget changes had gone the other way, it seems quite likely that the Chief Secretary would have pressed for full offsetting reductions in EFLs. Nevertheless, the Sub-Committee will probably feel that it would be right as the Chief Secretary proposes, to consider each industry case-by-case and to press the industries hard to cut back on current costs.

Prices

12. It should be possible to persuade quite a few industries to take a more optimistic view of their internal resources by pointing out that their economic assumptions are quite pessimistic. Tables F and G in the report by officials show that most industries are assuming fairly slow economic growth (about 1½ per cent a year after 1984-85) and much

higher inflation than the Government (over 6 per cent a year on average). On the other hand, past experience does not suggest that the industries will be successful in avoiding virtually any increase in the real earnings of their workforce (Table H), however justified on merits such an outcome might be.

13. It therefore seems likely that, as E(A)(84)36 hints, if the target is to be achieved, price increases will have to be significantly higher than the industries are assuming. Table I in the report by officials shows that the electricity supply industry in England and Wales is assuming a cumulative price reduction in real terms of about 7½ per cent over the period 1984-85 to 1987-88, and gas a real reduction of over 3 per cent, concentrated in the first two years. The Post Office and London Regional Transport are also assuming real reductions.

14. Given the low rate of return on assets of many public utilities there is clearly a good case for price increases. However, you will recall the serious difficulties with the gas and electricity industries at the end of the last public expenditure survey. The Secretary of State for Energy, in particular, is likely strongly to resist any suggestion that gas and electricity prices should be increased in real terms, or more rapidly than the industries themselves are willing to accept. No doubt he will point out that there is a review of gas prices currently in progress.

we've not heard much of this recently

15. It may be unnecessary to resolve any disagreement at tomorrow's discussion. However, in view of the importance of the subject, both intrinsically and because of the implications for the survey, you will wish to encourage Mr Walker to bring forward proposals on gas prices as soon

Also relevant is whether electricity prices are raised this year to cover the cost of oil burn.

as possible and to hold any necessary discussion of electricity prices with the Chief Secretary in good time for the issues to be resolved in the context of the survey.

HANDLING

16. You will wish to ask the Chief Secretary, Treasury to introduce his memorandum. You might then invite the Ministers with sponsoring responsibilities - Secretaries of State for Energy, Scotland, the Environment, Trade and Industry, and Transport - to comment, both generally and from the standpoint of the industries for which they are responsible. The Chancellor of the Exchequer may wish to comment on the economic assumptions, as well more generally; the Secretary of State for Employment may wish to comment on the pay assumptions.

CONCLUSIONS

17. You will wish the Sub-Committee to reach conclusions on the following.

(i) Whether the target for aggregate reductions in the external financing requirements of the nationalised industries should be as proposed by the Chief Secretary, Treasury, that is, reductions on base-line of £250 million in 1985-86, £ 500 million in 1986-87, and £1000 million in 1987-88.

(ii) Whether the guidelines for discussion with the nationalised industries should be as suggested in paragraphs 6 to 11 of E(A)(84)36.

(iii) Whether officials should pursue discussions with the industries on the basis of (i) and (ii) above, with a view to the Chief Secretary's reporting back in the Autumn after bilateral discussions with sponsoring Ministers.

PLG

P L GREGSON

Cabinet Office
3rd July, 1984

ANNEX

IFR : BASELINE AND BIDS

	1984-85	1985-86			1986-87			1987-88		
	Forecast Outturn	Baseline	Bid	Difference	Baseline	Bid	Difference	Baseline	Bid	Difference
EXPENDITURE										
Fixed Assets	5456	5240	5405	+ 165	5155	5264	+ 109	5282	5312	+ 30
Other	- 298	- 199	- 2	+ 197	- 110	- 44	+ 66	- 111	28	+ 139
	5158	5041	5403		5045	5220		5171	5340	
FINANCING										
Internal resources	2563	3670	3258	- 412	4713	3575	- 1138	4832	3704	- 1128
External financing	2595	1371	2145	+ 774	332	1645	+ 1313	339	1636	+ 1296
	5158	5051	5403		5045	5220		5171	6340	
RMPS and other Schemes		377	495	+ 118	382	397	+ 17	393	412	+ 19