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PRIME MINISTER 12 July 1985

NATIONALISED INDUSTRIES - IFR REPORT

Apart from gas, airports and buses, which are on the stocks for early privatisation, the nationalised industries are spending roughly £25 billion pa on operating costs and over £4 billion pa on capital investment.

In relation to these costs, currently of the order of £30 billion pa, Peter Rees is aiming for reductions of:

	(£ million)	1986/7	1987/8	1988/9
Eliminating	Additional bids:	495	240	560
Further cuts	Below baseline:	-	250	150
	TOTAL	495	490	710

plus an unspecified, but probably modest, reduction for the coal industry.

Thus, he is looking for budget reductions of the order of 2% - perhaps less.

If the Cabinet, faced with a compelling need to hold the line on public expenditure, was a company board faced with equivalent pressures, cost reductions on this scale would be seen as modest to say the least. The operating divisions would be told to define priorities, discard the nice to have but inessential, and reduce budgets by, say, 5% or more.

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Paradoxically, target reductions lower than this are often more difficult to achieve because they encourage endless fine-tuning rather than a radical review of priorities and essentials.

This sort of exercise is healthy rather than debilitating. It helps to counter the tendency in any large bureaucratic organisation to leave unchallenged the many pockets of waste, inefficiency and unproductive effort - which is why external consultants can achieve such striking results. Budget forecasts are invariably developed upwards from the bottom, layer by layer through the organisation. At the lower levels, the managers often lack the breadth of vision to spot the inefficient and the wasteful trade-offs. Layer upon layer of contingencies are built in. Higher up the organisation, management is not inclined to master the details sufficiently to root out the flaws and strip away the contingencies.

Merely getting back to baseline in 1986/7 should be no cause for satisfaction. Take British Steel and the Post Office for example - both bidding for an additional £80 million. The bids are groundless. Norman Tebbit has recently undertaken to hold the EFLs for steel. The Post Office bid assumes a reduction in the price of postage stamps.

Moreover, the miners' strike is now more a cause for viewing the projected EFLs with scepticism and suspicion than it is a cause for sympathetic consideration. We have already had to absorb a total overshoot of £1,930 million in 1984/5 and a possible £750 million in 1985/6 - what more?

Electricity (England and Wales) overshot by £1,270 million in 1984/5 and threatens to overshoot by more than £200 million in 1985/6. Additional bids of more than £600 million have been submitted for the next 3 years. Large additional fuel costs were incurred during the strike. What about the less obvious offsetting benefits - like the income from the exceptional 6% temperature-adjusted increase of electricity consumption this Spring, probably owing something to the depletion of coal stocks domestically and in industry. What about the lessons learnt during the strike which offer scope for future savings - eg cheaper transport from pit to power station?

British Steel have attributed a fat £170 million of additional costs to the miners' strike. They claim that the coal bought from abroad was dearer than UK coal. Yet some of the imported coal was considerably cheaper. They say that road convoys were more costly than rail, yet that was not the CEGB's experience. There would have been some losses from using smaller ports, using different types of coal, and losing some sales to the NCB itself, but £170 million looks generous.

<u>Conclusion</u>

The Treasury paper cautiously avoids detail, presumably because Peter Rees wants to keep his powder dry until the bilaterals. What he is looking for is robust support for a bid reduction target of the order of £0.5 billion for each of the next 3 years. He deserves more than robust support. He should be challenged for aiming at such a modest overall target when the need to contain public expenditure is so compelling. The attachment outlines some of the bigger targets which we should be gunning for.

JW

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ANNEX

MAJOR TARGETS FOR REDUCTION

Coal: The big target is capital expenditure - running at some £800 million pa. The forecast has been made by Hobart House assuming that the industry's structural problems continue to be tackled by applying the balm of capital investment (often uneconomical) rather than improving the abysmally low productivity.

To be dealt with in separate discussions

Electricity: If the industry's management was to attack the £9 billion operating budget with the same application as they handled the miners' strike, big savings should be in prospect. The additional bid of some £570 million in 1988-89 is based on some unrealistic - probably unsound - assumptions about the extent and rapidity of the nuclear programme following the Sizewell decision. Moreover, it has been assumed that electricity prices will be reduced in real terms in 1988-89.

Gas: The £270 million bid in 1986-87 represents the estimated additional cost of an ill-conceived gas contract for the Frigg Field in Norway. The forecast is based on questionable assumptions about future oil prices and exchange rates. The Treasury are talking about a significant real-terms price increase to gas consumers prior to privatisation as a means of boosting BGC's profit forecasts. That looks like questionable politics, and is unlikely to fool the experts in the City.

Railways: The £150 million increased bid for 1987-88 relates principally to new - and therefore more efficient and easily maintained - rolling stock for the Provincial Sector. In view of the gross underloading of BREL, the maintenance saving needs to be challenged. More generally, the merit of investing heavily in a hugely unprofitable sector faced with the prospect of radical change in the shape of bus substitution, is questionable.

Brit.Steel/ Post Office: As indicated in the body of the text, the additional bids - each of £80 million for 1986-87 - are groundless. Why should a Government desperate to hold down public expenditure reduce the cost of postage stamps?