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PRIME MINISTER

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Nationalised Industries:
1985 Investment and Financing Review (IFR)

E(A)(85)42

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. The main focus of the review reflects the Government's privatisation programme; industries are within the scope of the review until actually privatised, with the result that the aggregate figures for the current year and 1986/87 include the British Gas Corporation (BGC), British Airports Authority (BAA) and National Bus Corporation (NBC). The review assumes that all three corporations will be privatised in the course of 1986/87, and they are therefore excluded from the figures for the later years. British Airways, now a PLC, is excluded throughout.

2. The recent history of nationalised industries financing is dominated by the miners' strike and its aftermath, which have greatly increased nationalised industries' requirements for external finance during 1984/85 and the current financial year. The main elements in the overall picture for the three years covered by the review are summarised in the following table.



INDUSTRIES EXCLUDING BGC, BAA, NBC

	£ million		
	1986-87	1987-88	1988-89
1. Baseline for external financing requirements	553	185	192
<u>Additional bids</u>			
2. Investment	+ 359	+ 238	+ 255
3. Working capital	+ 141	+ 385	+ 397
4. Total capital requirements increase	+ 500	+ 633	+ 651
5. Business cash flow	- 579	- 4	- 168
6. Change in asset sales	+ 76	+ 62	+ 60
7. Total internal resources	- 503	+ 58	- 108
8. Total external financing additions (line 4 minus line 7)	+1003	+ 575	+ 759
9. of which coal	+ 508	+ 333	+ 198
10. Other industries	+ 495	+ 242	+ 561
11. Chief Secretary's objective for industries except coal (change from baseline)	-	- 250	- 150
12. Implied reductions below industries' bids (line 11 minus line 10)	- 495	- 492	- 711

3. In addition to the additional bids shown above, a projected deterioration in the cash flow as compared to the baseline of the industries to be privatised adds a further £304 million (mostly on account of BGC) to the additional bid for external finance in 1986-87. The Chief Secretary proposes that the case for early real gas price increases should be considered before the end of this year; if such increases were made they could contribute both to reducing the additional external financing requirement before privatisation and to increasing the privatisation proceeds.

Labour interest



4. The Chief Secretary proposes to deal with coal separately outside the IFR; the figures are highly provisional, and in addition to the impact of the strike and its aftermath on NCB finances, account will need to be taken of a substantial additional bid (£183 million in 1986-87) for the Redundant Miners' Payments Scheme, where expenditure falls on Votes. Because part of this expenditure represents an acceleration of the projected run down of the workforce, this additional bid is partly offset by savings of £44 million and £50 million in 1987-88 and 1988-89.

5. The Chief Secretary's proposals for reductions below the industries' initial bids are more modest than last year, when at the comparable stage he urged cuts of £1 billion, £1.8 billion and £2.3 billion for the three survey years; on this occasion he is asking for cuts of £500 million, £500 million and £700 million. If his proposals are approved, officials will hold discussions with the industries, and he will then report back around the end of September, following bilateral discussions with the sponsor Ministers.

MAIN ISSUES

6. Cabinet have already agreed that the Public Expenditure Planning Totals as set out in the 1985 Financial Statement and Budget Report should be maintained, with cash provision in 1988-89 set 3 per cent above the 1987-88 total. Other Ministers will no doubt accept that a substantial reduction in the total of the nationalised industries' additional bids is required; and as the Chief Secretary says, many of the figures are 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) How might the bids be cut back?



Scale of reductions

7. As the coal strike has demonstrated, very big changes can occur within a short time in nationalised industries' needs for external financing, which - like the PSBR - are the difference between much larger figures of total spending and receipts. The industries notoriously 'pad' their figures at this stage of their presentation to Government, and substantial adjustments should be possible without too much difficulty. However, the total reductions sought are broadly of the same magnitude as the total additional capital requirements put forward, and eliminating all these is unlikely to be easy. As more industries are privatised, it is bound to become harder to secure any given volume of reduction from the rest; BGC have in recent years been a source of cash generation to the public sector, and gas and airports have probably offered more scope than other industries for price increases to improve the overall IFR position.

Means of securing reductions

8. The following possibilities are in principle open to the Government:

- (i) reducing the industries' capital requirements;
- (ii) improvements in the industries' operating performance;
- (iii) price increases;
- (iv) higher receipts from asset sales.

As already noted, some economies are likely to be possible on capital expenditure, particularly by the electricity industry, the railways and water. Pressure will need to be maintained on the industries to reduce their costs, by setting tough but realistic cost reduction targets. Overall the industries are projecting a moderate improvement in real unit costs, but some may be over-optimistic in looking to real reductions in wage levels for their employees. There are some signs that the industries may have underestimated growth in the economy over the



next year, which would suggest a better out-turn on internal resources; and, steel's current performance as set out in E(A)(85)45 is better than the provisional figures used in the IFR. Water and railways are already projecting real price increases, and the scope for price increases by some of the other major industries (coal, steel and electricity) is likely to be constrained by competition (coal and steel) or by the operation of the agreed financial target (electricity). Receipts from asset sales are substantially above baseline, and although efforts will be made to increase them still further, the scope for doing so must be diminishing.

9. The Chief Secretary proposes no particular emphasis in the pursuit of reductions; rather each industry's position will need to be examined, and the scope for reductions in external financing considered under each of the possible approaches.

HANDLING

10. 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 as more generally; the Secretary of State for Employment may wish to comment on the pay assumptions.

CONCLUSIONS

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

- (i) Whether the coal industry, about whose future there is particular uncertainty, should be treated separately, with the aim of reducing the total additional bid (including that for the RMPS) to the minimum.



(ii) Whether the industries about to be privatised should be controlled as hitherto up to the time of privatisation, and whether the case for an early real price increase for gas should be considered.

(iii) Whether the target for aggregate reductions in the external financing limits of the remaining nationalised industries should be as proposed by the Chief Secretary, Treasury - i.e. maintenance of the present baseline for 1986-87, and reductions of £250 million and £150 million below baseline for the two succeeding years.

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

J B UNWIN
Cabinet Office
16 July, 1985

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2nd July 1985

CABINETMINISTERIAL STEERING COMMITTEE ON ECONOMIC STRATEGY

SUB-COMMITTEE ON ECONOMIC AFFAIRS

NATIONALISED INDUSTRIES: 1985 INVESTMENT & FINANCING REVIEW (IFR)

Memorandum by the Chief Secretary,
Treasury

I attach a review by officials of the nationalised industries' opening bids for external finance for 1986-87 to 1988-89. Table A annexed to this paper shows the key figures for each industry and the comparison with the baselines.

Industries to be Privatised

2. Table A shows separately the figures for the 3 industries which we have said we intend to privatise as soon as possible - Gas, Airports and Buses. Their external financial requirements will continue to be included within the public expenditure planning total until the date they are privatised. I have assumed that for each industry this will be during, or very soon after, 1986-87. There are, therefore, no entries for the two following years.

3. The figures for 1986-87 are inevitably uncertain, particularly those for Gas. Because of its financing profile, if Gas were privatised in autumn 1986 its negative EFL to that date would be less than if it were to remain in the public sector to the end of the year; moreover, the industry is now warning of a deterioration in its cash flow in this year and in 1986-87.

4. In deciding how to deal with the industries' total bids I think it sensible to put these 3 industries in a separate category. I am not seeking endorsement of a particular target

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figure for these 3 industries. But we must be clear that until the 3 industries are privatised the Government stands behind them, and that their external financing requirements, whether positive or negative, score as public expenditure. We must therefore continue to ensure in the meantime that their financing requirements are fully scrutinised, monitored and controlled. In particular, I propose that we look at the case for Gas price increases higher than inflation by no later than January 1986, which would help both in dealing with these financing requirements and also with receipts from the sale.

The Remaining Industries

5. The position is summarised below:

	£ million (cash)		
	<u>1986-87</u>	<u>1987-88</u>	<u>1988-89</u>
Baseline for external financing requirements	553	185	192
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Additional bids:			
Capital requirements	+500	+633	+651
Internal resources	-503	+58	-108
<hr/>			
TOTAL external financing additions	1,003	575	759
of which Coal	508	333	198
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*RMPS additions	183	-44	-50
TOTAL Coal additions	691	289	148
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*the Redundant Mineworkers' Payments Scheme is not part of the NCB's external finance but needs to be considered with it.

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The Position of the Coal Industry

6. The coal industry is in a different position from the other industries this year. The effects of the recent strike are, in part, reflected in very large additional bids - more than half of all bids in 1986-87. The strike also raises more fundamental issues about the industry than it is usual to pursue in the annual IFR discussions.

7. For these reasons I propose to discuss separately with the Secretary of State for Energy the Coal Board's finances. My aim will be to reduce the Board's requirements to an absolute minimum. In view of the uncertainties which still surround the figures I do not seek EA's endorsement for any particular target.

Other Industries

8. Setting aside the consequences of the coal strike we have made good progress in turning round the industries' finances. We cannot afford to let up now and to retreat from the plans we have published. As colleagues will see from the assessment I am putting to Cabinet, we again face a formidable task in keeping to overall public expenditure planning totals. Insofar as we fall short on our targets for the nationalised industries, that task will be even more difficult. It follows that we must not only substantially reduce the industries' bids but, where we can, we must look for savings below their present baselines.

9. I think this is an achievable objective. Excluding coal, the bids compared to baseline are £495m in 1986-87, £242m in 1987-88 and £561m in 1988-89. We know from experience that some of the industries will have put in high and cautious bids to establish their opening negotiating position. I would expect to make quite large reductions relatively painlessly.

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10. It would be premature to make detailed proposals now for the individual industries. Officials need to do a good deal of detailed work in scrutinising the proposals, and in some cases new Corporate Plans. However, while the possibilities vary for individual industries, I suggest that there are a number of general points which should be borne in mind.

Current Costs & Profitability

11. Although some good progress has been made, we still need to press for increasing profitability and for reductions in the subsidies to the loss-makers. So far as possible we must achieve this through cost reductions, and improvements in efficiency. To this end we must be satisfied that all the industries have tough cost reduction targets in place, and that their plans throughout the period are realistic in the assumptions made for the rolling forward of performance targets. This is particularly important for those industries not facing the full forces of competition. We must also be satisfied, where an industry's financial target runs out during the period now under review, that there are realistic assumptions in the later years for the next target and for economic pricing.

Capital Requirements

12. A number of the industries are making big additional bids for further investment. Given our need to make reductions, we must look at these proposals very critically. There should be scope for easing our problems both by cutting projects and by looking for more realistic assumptions for the timing of starts and for the phasing of expenditure.

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13. The industries are again looking in aggregate for large increases in their working capital. There might be good reasons for this but we need to scrutinise it very carefully. We know from past experience that this is an area where the industries often try to cushion themselves.

Sale of Fixed Assets

14. The opportunity is open to the industries to improve their contributions from internal resources by the sale of fixed assets, including surplus land. The present initial bids show about £145 million in total for 1986-87 falling to under £100 million in 1988-89. It may be that this decline is simply a function of the earlier sale of the more attractive and easily disposable assets. But we must scrutinise this carefully, both in the interests of reducing the industries' bids and, more widely, as part of our current initiative to speed the disposal of surplus public sector land and empty housing. In approving financing requirements, and in due course EFLs, we must ensure that they assume tough targets for disposals.

Conclusions

15. We must cut the industries' opening bids sharply, both to sustain our progress in improving their financial performance and to contribute to dealing with the problems we face in the overall public expenditure exercise. The more we can reduce their call on public funds the more scope we shall have to meet our own spending priorities.

16. For the reasons given in paragraph 6 above I propose to discuss separately the Coal Board's finances with the Secretary of State for Energy.

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17. For the remaining industries, I propose we agree a tough but realistic target of keeping to the baseline in 1986-87 and securing reductions of £250m below baseline in 1987-88 and £150m below baseline in 1988-89. This broadly matches the profile of the industries' financing estimates, but assumes as I think is right that they are capable of improving their performance.

18. I invite the Sub-Committee:

(i) to note the position on Gas, Airports and Buses, the continuing need to scrutinise, monitor and control their financing requirements until the date of their privatisation, and the need to consider the case for early real price increases in Gas (paragraphs 2 - 4);

(ii) to agree that I should discuss separately the Coal Board's finances with the Secretary of State for Energy with aim of substantially reducing the Coal Board's requirements for finance and to report back to colleagues by early October (paragraphs 6 and 7);

(iii) to agree that, in the further work by officials and in my subsequent bilateral discussions with Ministers, the overall aim for the remaining industries should be to reduce their requirement for external finance to the baseline in 1986-87, to £250m below baseline in 1987-88 and to £150m below baseline in 1988-89 (paragraph 17).

PR

H.M. TREASURY

2nd July 1985.

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NATIONALISED INDUSTRIES FINANCIAL INFORMATION SYSTEM

INVESTMENT AND FINANCING REVIEW 1985

External finance

£ million cash (1)

	1985-86	1986-87			1987-88			1988-89		
	Estimated outturn	baseline	Initial bid	change	baseline	Initial bid	change	baseline	Initial bid	change
NATIONAL COAL BOARD	1030	382	890	: +508 :	392	725	: +333 :	402	600	: +198 :
ELECTRICITY (ENGLAND AND WALES)	-469	-1447	-1278	: +169 :	-1487	-1611	: -124 :	-1524	-956	: +568 :
NORTH OF SCOTLAND HYDRO-ELECTRIC BOARD	-19	12	13	: +1 :	9	18	: +9 :	9	6	: -3 :
SOUTH OF SCOTLAND ELECTRICITY BOARD	242	112	253	: +141 :	-10	29	: +39 :	-10	-107	: -96 :
BRITISH STEEL CORPORATION	360	171	251	: +80 :	136	169	: +33 :	139	139	: - :
POST OFFICE	-70	-55	25	: +80 :	-60	-5	: +55 :	-62	-42	: +20 :
NATIONAL GIROBANK	-3	-3	-3	: - :	-3	-3	: - :	-3	-3	: - :
BRITISH RAILWAYS BOARD	854	792	782	: -10 :	768	921	: +153 :	790	877	: +87 :
BRITISH WATERWAYS BOARD	45	46	47	: +1 :	47	49	: +2 :	48	52	: +4 :
SCOTTISH TRANSPORT GROUP	15	6	5	: - :	6	5	: -2 :	7	6	: -1 :
BRITISH SHIPBUILDERS (MERCHANT)	-	75	75	: - :	59	59	: - :	60	45	: -15 :
CIVIL AVIATION AUTHORITY	40	15	15	: - :	10	10	: - :	10	10	: - :
WATER (ENGLAND AND WALES)	195	123	148	: +25 :	15	76	: +62 :	15	32	: +17 :
LONDON REGIONAL TRANSPORT	323	325	333	: +8 :	303	318	: +15 :	311	293	: -18 :
Sub Total	2543	553	1556	+1003	185	760	+575	192	951	+759
BRITISH GAS CORPORATION (3)	-100	-470	-200	: +270 :						
BRITISH AIRPORTS AUTHORITY	-21	-	30	: +30 :						
NATIONAL BUS COMPANY	48	-	4	: +4 :						
Total Industries	2470	83	1390	+1307	185	760	+575	192	951	+759
Redundant Mineworkers Payments Scheme (2)	384	303	486	+183	317	273	-44	325	275	-50
BRB Pension Fund Deficiency Payments (2)	84	91	91	-	93	93	-	96	96	-
Shipbuilding Redundancy Payments Scheme (2)	36	6	17	+11	1	4	+3	1	1	-

Notes

- (1.) All figures to nearest £ million. Totals may differ due to rounding.
 (2.) Memorandum items - payments outside the external finance bids but presented here for ministerial convenience.
 (3.) No bid yet received from BGC; Department's best estimate included. This is subject to significant variation dependent upon assumption over timing of privatisation.