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CABINET
MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

NATIONALISED INDUSTRIES'
1981 INVESTMENT AND FINANCING REVIEW

Memorandum by the Chief Secretary, TREASURY

The attached review by officials sets out the nationalised industries' claims for additional finance above the levels in Cmnd 8175. These are very large, amounting in 1982-83 to £2.5 billion above Cmnd 8175 revalued, £3.2 billion in 1983-84 and £3 billion in 1984-85 (after correcting for the gas levy). They represent the wish of most industries to maintain, and in some cases to increase, their expenditure in the face of declining revenues caused by the recession.

2. Claims on this scale are totally unacceptable. About half the planned reduction in public expenditure between 1980-81 and 1983-84 depends on reducing the nationalised industries' call for external finance. The new claims now put forward could only be accommodated within our overall public expenditure objectives by damaging cuts in other public services. To endorse the industries' plans in full would mean allowing them to pre-empt an increasing share of the limited additional resources likely to be available within the

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economy over the next 3 years. The size of the additional bids is strong evidence of the industries' unwillingness to make the kind of adjustments demanded - and secured - by the private sector in tight economic circumstances. We cannot allow the fact of Government ownership of the industries to cushion them as they would like.

Decisions required

3. To succeed in our objectives for public expenditure and hence our overall economic strategy, we need to take decisions now about whether we can afford any increase in the nationalised industries' demands for additional finance over the levels in Cmnd 8175 and, if so, by how much. In taking these decisions, we should bear in mind that even the appalling forecasts we now have may not reflect the industries' maximum expectations. The figures for BS and BSC may need adjustment when their Corporate Plans have been assessed, as may the British Rail figures for later years. Those for the NCB are taken from their recent medium term prospectus which has not yet been fully considered. More generally, the industries' forecasts are based on views more optimistic than our own about the speed and size of the upturn. Without firm decisions now, this could result, as last year, in further bids in the autumn.

4. I would be prepared to accept an increase of £750 million in each year in the aggregate position for nationalised industries. This is, in my view, the maximum acceptable in relation to other public expenditure programmes and the most we can prudently transfer from the Contingency Reserve. It would also offset a considerable part of the impact on the industries' finances of the more pessimistic view they are taking this year, compared with last, of the economic outlook. Even so, their claims would exceed what we can afford by £1.75 billion in 1982-83, £2.5 billion in 1983-84 and £2.25 billion in 1984-85.

5. It is important to take the necessary decisions now so that they can be communicated to the industries before the summer holidays. This will help to ensure that their revised forecasts for 1982-83 EFLs are based on the finance likely to be available: otherwise for that and ^{for} later years they will continue to plan on an unrealistic basis. Without such decisions, we risk the ever-escalating bids which proved so difficult to handle last year and a repetition in each year's public expenditure exercise of the need for cuts in other programmes to accommodate the industries.

Allocation of additional finance/reductions

6. We must therefore decide now on what basis to allocate the additional £750 million and - the opposite side of the same coin - what revisions to require in the industries' forward plans. The annexes to this paper set out three alternative ways in which this might be done.

7. The first approach set out in Annex 1 would be to restrict industries for 1982-83 and 1983-84 to 85% of the investment levels approved last year (ie, of the levels in Cmnd 8175) and to a broadly similar aggregate figure for 1984-85 (which was beyond the horizon of last year's White Paper). The figures for 1982-83 would thus be equivalent to the investment approvals already given to the industries (with the exception of the NCB) for that year.

At the same time we would indicate explicitly to the industries that we would be prepared to approve higher levels of investment to the extent that the industries generated sufficient additional internal resources to finance the increases. The intention would be to put maximum pressure on the industries to achieve cuts in current costs or additional sales volume in order to finance the levels of investment they considered desirable. It could also force them to assess much more rigorously than at present the priorities within their investment programmes. The disadvantage of this approach would be that the industries

would present this option as a damaging assault on capital expenditure and would undoubtedly point to desirable projects which were being squeezed out. On the other hand, the merit of the approach is that the capital programmes can be effectively

controlled and this is thus the only certain way of achieving the necessary reductions in the industries' total financial demands.

8. The second approach, which is more in line with our general approach to the industries, would be to secure the necessary revisions ^{estimated} in the industries' /plans by reference to the industries' current costs. Although not formally a selective approach, the distribution between industries (set out in Annex 2) would broadly reflect the scope for current cost savings. Reductions in external finance equivalent to ^{about} 5% of current costs in 1982-83, 7% of current costs in 1983-84 and 5½% in 1984-85 would be needed. It would be up to the industries to decide what changes to make in their plans within the limited additional finance allowed. We would need to make it plain to the industries that they should identify real savings in current costs, falling back on reductions in capital programmes only to the extent they failed to achieve these. The intention would be to put pressure on the area in which the industries' performance is generally less good than that of the private sector and where this year's ^{IFR} plans suggest that greater realism and better control could achieve savings. For example, on pay, many industries are building pessimistic/extravagant expectations into their plans. The disadvantage of this approach, compared with that in the previous paragraph, is that we would be less certain of achieving our objectives: the industries might commit too much of their investment at an early stage and return with further bids for additional finance if they fail to make forecast savings in current costs.

9. The final alternative is a more selective approach. Ideally, we ought to require changes in individual industry's plans to reflect a considered collective judgement on priorities. Factors which we might take into account would be industrial priority; each industry's potential for improved financial performance and its track record; and its success in controlling costs and adjusting to recession. We use these criteria to allow some specific additional bids in particular industries, but as a necessary conse-

quence, rein back even harder on the remaining industries. In principle, this would be a more rational approach. But this year, given the size of the problem we confront, it is difficult to carry the approach very far. Annex 3, however, sets out a proposal for distributing the additional finance/necessary savings implied by the current cost options in a way which takes more account of performance and priorities. The basis of the distribution is very broadly to achieve the same total reduction in the industries' financial demands by seeking larger revisions (equivalent to current cost savings of 6%, 8% and 6% in each of the three years respectively) from most industries, in order to limit the revisions required from those industries most exposed to market forces, whose room for manoeuvre is thereby limited and who have already taken steps to cut back their investment and labour forces.

Summary and recommendation

10. On the assumption that we can provide as much as £750 million a year extra for the nationalised industries, colleagues will want to consider which of the three approaches outlined above will best secure our objectives for the industries both in public expenditure terms and in terms of the industries' efficiency. Whichever approach we adopt, I would propose that each sponsor Minister should be able to alter the balance of overall savings between his industries if that seemed desirable.

11. Decisions now are essential. We will need to take an early decision on NCB's 1982-83 EFL (ahead of the wage negotiations beginning in the next few weeks) on a basis no less stringent than that we adopt for other industries. More generally, unless we inform the industries now of the maximum finance likely to be available, they will not even start revising their plans in the right direction. If we cannot agree on a distribution now, we should ask them to put forward their bids for 1982-83 EFLs on the assumption that their investment programmes will not exceed the "85% approval"

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level agreed last year, except to the extent that these were accompanied by firm proposals for generating additional internal resources.

12. I recommend the Committee:

(i) to agree that an additional £750 million a year should be provided for the industries' external finance but that their remaining demands are unacceptable and must be eliminated;

(ii) to decide on the most appropriate method of allocating the additional funds and ^{thus} distributing the necessary savings of £1.75 billion in 1982-83, £2.5 billion in 1983-84 and £2.25 billion in 1984-85;

(iii) to invite sponsor Ministers to inform the industries of these provisional decisions so that they can be taken into account in the industries' planning, particularly in the forecasts which the industries will need to put forward by mid-September for their 1982-83 EFLs;

(iv) to agree that action is essential now if the industries' financial demands are not to escalate further and that, failing agreement on a method of distributing the additional funds/savings as at (ii), the industries should be told to put forward their revised forecasts for 1982-83 on the basis that their investment expenditure will be held at or below the 85% levels approved last year.

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OPTION CUTS PACKAGES: (i) Investment - related savings (based on fixed assets expenditure)

| | 1982-83 | | |
|-------------------|---|------------------------------|--------------------------------------|
| | Existing Investment approval (85% of Cmd 8175 figure) | Investment Claim in 1981 IPR | OPTION Cut back to existing approval |
| NCB | 848** | 1022 | - 174 |
| EC + B's | 1120 | 1419 | - 299 |
| BGC | 758 | 989 | - 231 |
| ENOC | 327 | 454 | - 127 |
| BSC | N/A | N/A | N/A |
| BT | 1771 | 2537 | - 766 |
| FO | 91 | 170 | - 79 |
| National Girobank | 7 | 10 | - 6 |
| BS | 33 | 60 | - 27 |
| BAB | 230 | 249 | - 19 |
| BAA | 150 | 167 | - 17 |
| BRB | 392 | 455 | - 63 |
| BTDB | 20 | 15 | * |
| NPC | 48 | 45 | * |
| NBC | 79 | 66 | * |
| BWB | 3 | 7 | - 4 |
| NSHEB | 41 | 56 | - 15 |
| SSEB | 315 | 421 | - 106 |
| STG | 13 | 14 | - 1 |
| TOTAL | 6246 | 8156 | - 1936 |

| | 1983-84 | | |
|-------|--------------------------|------------------------------|---|
| | 85% of Cmd 8175 figure** | Investment Claim in 1981 IPR | OPTION Cut back to 85% of Cmd 8175 figure |
| | 921 | 1133 | - 212 |
| | 1238 | 1584 | - 346 |
| | 709 | 1041 | - 332 |
| | 334 | 503 | - 169 |
| | N/A | N/A | N/A |
| | 1867 | 2977 | - 1110 |
| | 96 | 156 | - 60 |
| | 4 | 6 | - 20 |
| | 42 | 92 | - 50 |
| | 310 | 348 | - 38 |
| | 111 | 190 | - 79 |
| | 422 | 540 | - 118 |
| | 23 | 17 | f |
| | 48 | 48 | f |
| | 88 | 81 | f |
| | 3 | 8 | - 5 |
| | 42 | 52 | - 10 |
| | 367 | 434 | - 67 |
| | 14 | 15 | - 1 |
| TOTAL | 6639 | 9255 | - 2629 |

| | 1984-85 | | |
|-------|----------------------------------|------------------------------|---|
| | 95% of implied Cmd 8175 figure## | Investment Claim in 1981 IPR | OPTION Cut back to 95% of implied Cmd 8175 figure |
| | 1081 | 1270 | - 189 |
| | 1453 | 1850 | - 397 |
| | 832 | 991 | - 159 |
| | 392 | 670 | - 278 |
| | N/A | N/A | N/A |
| | 2191 | 3261 | - 1070 |
| | 113 | 164 | - 51 |
| | 5 | 6 | - 1 |
| | 48 | 120 | - 72 |
| | 364 | 367 | - 3 |
| | 131 | 221 | - 90 |
| | 496 | 600 | - 104 |
| | 27 | 19 | f |
| | 57 | 53 | f |
| | 103 | 91 | f |
| | 4 | 9 | - 5 |
| | 48 | 57 | - 9 |
| | 431 | 403 | f |
| | 16 | 14 | f |
| TOTAL | 7792 | 10,166 | - 2428 |

Notes: * Indicates that industry is already below investment approval level.

f Indicates no cut possible with given formula

** Existing approval is for 70% of Cmd 8175 figure

1983-84 figure revalued to estimated outturn prices, plus 5 per cent

OPTION CUTS PACKAGES: (ii) Current cost^(a) related savings

| | 1982-83 | | 1983-84 | | 1984-85 | |
|---------------------|-------------------------|----------------------------|-------------------------|----------------------------|-------------------------|----------------------------|
| | Estimated Current Costs | OPTION 5% of Current Costs | Estimated Current Costs | OPTION 7% of Current Costs | Estimated Current Costs | OPTION 5% of Current Costs |
| NCB | 4900 | - 245 | 5390 | - 377 | 5929 | - 326 |
| EC & B's | 7228 | - 361 | 7951 | - 557 | 8746 | - 481 |
| BGC ^(b) | 3227 | - 161 | 3517 | - 246 | 3834 | - 211 |
| BNOC ^(c) | 289 | - 14 | 323 | - 23 | 358 | - 20 |
| BSC | 4040 | - 202 | 4444 | - 311 | 4888 | - 269 |
| BT | 3644 | - 182 | 4008 | - 281 | 4409 | - 242 |
| BO | 2660 | - 133 | 2926 | - 205 | 3219 | - 177 |
| National Girobank | 208 | - 10 | 231 | - 16 | 257 | - 14 |
| BS | 1275 | - 64 | 1354 | - 95 | 1456 | - 80 |
| BAB | 2143 | - 107 | 2422 | - 170 | 2688 | - 148 |
| BAA | 210 | - 11 | 231 | - 16 | 248 | - 14 |
| BRB | 3300 | - 165 | 3590 | - 251 | 3884 | - 214 |
| BTDB | 139 | - 7 | 150 | - 11 | 161 | - 9 |
| NFC | 506 | - 25 | 557 | - 39 | 618 | - 34 |
| NBC | 604 | - 30 | 670 | - 47 | 737 | - 41 |
| BWB | 49 | - 2 | 53 | - 4 | 55 | - 3 |
| NSHEB | 210 | - 11 | 231 | - 16 | 254 | - 14 |
| SSEB | 588 | - 29 | 647 | - 45 | 705 | - 39 |
| STG | 160 | - 8 | 174 | - 12 | 190 | - 10 |
| TOTAL | 35,380 | - 1767 | 38,869 | - 2722 | 42,636 | - 2346 |

Notes: (a) Wages plus associated costs plus other operating expenditure, but excluding depreciation. (b) After deducting gas costs.

(c) Turnover related to equity oil business, less current cost operating profit, depreciation, other adjustments and margin.

General note All figures are approximate; for most industries, estimates are based on forecasts for 1981-82, uprated for inflation using industries' assumptions.

OPTION CUTS PACKAGES: (iii) Selectively applied current cost savings (a)(b)

| | 1982-83 | | | | 1983-84 | | | | 1984-85 | | | |
|-------------------|-------------------------|--------|--------------|-------|-------------------------|--------|--------------|-------|-------------------------|--------|--------------|-------|
| | Estimated current costs | 6% cut | 2% cut | other | Estimated current costs | 8% cut | 3% cut | other | Estimated current costs | 6% cut | 3% cut | other |
| NCB | 4,900 | -294 | | | 5,390 | -431 | | | 5,929 | -356 | | |
| EC + B's | 7,228 | -434 | | | 7,951 | -636 | | | 8,746 | -525 | | |
| BGC | 3,227 | -194 | | | 3,517 | -281 | | | 3,834 | -230 | | |
| ENOC | 289 | | | - 60 | 323 | | | - 70 | 358 | | | - 70 |
| BSC | 4,040 | | -81 | | 4,444 | | -133 | | 4,888 | | -147 | |
| BT | 3,644 | -219 | | | 4,008 | -321 | | | 4,409 | -265 | | |
| PO | 2,600 | -160 | | | 2,926 | -234 | | | 3,219 | -193 | | |
| National Girobank | 208 | - 12 | | | 231 | - 18 | | | 257 | - 15 | | |
| ES | 1,275 | | -26 | | 1,394 | | - 41 | | 1,456 | | - 44 | |
| BAB | 2,143 | | -43 | | 2,422 | | - 73 | | 2,688 | | - 81 | |
| BAA | 210 | - 13 | | | 231 | - 18 | | | 248 | - 15 | | |
| HRB | 3,300 | | | -135 | 3,590 | | | -105 | 3,884 | | | -197 |
| BTDB | 139 | | - 3 | | 150 | | - 5 | | 161 | | - 5 | |
| NFC | 506 | | -10 | | 557 | | -17 | | 618 | | - 19 | |
| NBC | 604 | | -12 | | 670 | | -20 | | 737 | | - 22 | |
| BWB | 49 | - 3 | | | 53 | - 4 | | | 55 | - 3 | | |
| NSHEB | 210 | - 13 | | | 231 | - 18 | | | 254 | - 15 | | |
| SSEB | 588 | - 35 | | | 647 | - 52 | | | 705 | - 42 | | |
| STG | 160 | | - 3 | | 174 | | - 5 | | 190 | | - 6 | |
| TOTAL | 35,380 | | -1750 | | 38,869 | | -2500 | | 42,636 | | -2250 | |

Notes

- a. Savings have been calculated on the basis of across-the-board percentages of 6 per cent, 8 per cent and 6 per cent for non-competing industries, 2%, 3% and 3% for competitive industries (BSC, ES, BAB, BTDB, NFC, NBC and STG), £60m, £70m and £70m for ENOC, and the residual required to reach the desired total for British Rail.
- b. Current costs are as defined for Option (ii). All figures are therefore approximate.

NATIONALISED INDUSTRIES'

INVESTMENT

AND

FINANCING

REVIEW

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NATIONALISED INDUSTRIES: INVESTMENT & FINANCING REVIEW 1981

Decisions Required

1. The Investment & Financing Review (IFR) is a forward look at the NIs' investment and financing requirements 1982-83 to 1984-85. It is a joint report of the Treasury and sponsor Departments after discussions with the individual industries concerned.
2. The report is intended to provide a basis for Ministerial decisions on external finance for the nationalised industries in aggregate and investment for each industry for each of the years in question.
3. The starting point for these decisions is the investment programmes and financing plans submitted by the industries in April, and revised during consultations since then between the industries, sponsor Departments and Treasury. The plans flow from the industries' own Corporate Plans which were prepared in many cases some months ago. This year's review has to be prepared in advance of medium-term plans for steel, shipbuilding and airways, whilst the figures for coal and rail represent a first guess at figures for the 1981 plan. Although planning procedures in individual industries vary, the industries should normally plan to meet their financial targets and this will in turn ensure that the investment programmes they put forward taken as a whole meet the required rate of return (RRR) (5% in real terms) or other agreed justification for new investment programmes.
4. Decisions on external finance for these years are a necessary part of settling public expenditure planning totals for eventual inclusion in the Public Expenditure White Paper. In relation to 1982-83 they provide a basis for fixing the industries' external financing limits (EFLs) in the autumn, taking account of more up-to-date forecasts which the industries provide in September.
5. Decisions on investment are normally taken on the basis of approving 100% of the agreed investment programme for Year 1 (1982-83), approving 85% of the programme for Year 2 (1983-84) and approving 70% for Year 3 (1984-85). Early decisions help the

industries to plan next year's investment sensibly. But in accordance with the procedure adopted last year investment approvals beyond the 85% already approved will need to be delayed until the EFLs are settled in the autumn in order to avoid pre-empting Ministers' room for manoeuvre.

6. The financing figures which result from the industries' planning procedures are inherently volatile. They are the residual between two much larger flows comprising capital requirements, of the order of £7bn in 1981-82, and internal resources, of the order of £5bn. The latter is itself the difference between two larger flows, revenue and expenditure, both of which are sensitive to such factors as fluctuations in demand, market share, productivity, the exchange rate, the relative movement of pay and prices and even the weather. This volatility, together with the convention that industries are free to put forward investment programmes which meet the RRR is the reason why, unlike the rest of public expenditure, plans which go into the IFR do not automatically start from a baseline of the previous White Paper. However the additional bids for finance by the industries this year are exceptionally large. In the circumstances of this year's review it must be our aim to eliminate as far as possible any excess over the White Paper figures.

The IFR as a Whole

7. Cmnd 8175 envisaged a substantial reduction (from £2270m* in 1981-82 to £60m in 1983-84) in the totality of the nationalised industries' demands for public expenditure. This transformation in the industries' finances was based on forecasts produced by the industries themselves reflecting their expectations of improved performance in a more favourable economic climate than now seems likely. It was to be achieved primarily by policies of economic pricing in gas and electricity, the reduction of losses in steel, coal, railways and shipbuilding, and greater efficiency by the industries as a whole. This turnaround in financing requirements was always recognised by Ministers as ambitious, even before the onset of the recession and reduced growth prospects. Successive White Papers have emphasised that because the industries are trading bodies, the figures for external finance for the later years must be extremely uncertain.

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*Cmnd 8175 figures are revalued to outturn (cash) basis throughout the report.

ANALYSIS OF CHANGES FROM CMND 8175

8. The figures submitted by the industries on the basis of their latest forecasts (some of which have been revised while the IFR discussions were in progress and some of which will be further revised on up-to-date assumptions later in the year) show a financing requirement greatly in excess - by more than £2bn-£3bn in each year of the IFR - of the figures in Cmnd 8175. Even so, the figures are incomplete because up-to-date forecasts are not available for a number of industries. There are no agreed figures beyond 1981-82 for the British Steel Corporation and British Shipbuilders. For these industries the sponsor Departments and Treasury have agreed notional figures for the purposes of the IFR; these have not been agreed with the industries.

9. The excess over the White Paper figures is the result of two main factors working in combination:

i) Some increase in planned capital requirements, rising from £400m in 1982-83 to £1260m in 1984-85 reflecting investment, notably in British Gas, BNOC, British Telecom, Post Office and British Shipbuilders.

ii) A shortfall in internal resources due to a more pessimistic view of market prospects and hence lower revenue forecasts: this is the main factor at work accounting for about £2bn of the total excess in 1982-83 and 1983-84, and for about £1750m in 1984-85. All the industries are affected except for the Post Office, British Airports Authority, British Shipbuilders and British Airways.

10. Discussions with the industries have led to proposals to defer expenditure and reduce costs which has reduced the bids for finance by roughly £200m in each of the 3 years. The overall position incorporating these reductions and compared with the figures in Cmnd 8175 revalued to cash is set out in the table below. The changes for individual industries are in Appendix A, Table 1.

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£ million (cash)

| | 1982-83 | 1983-84 | 1984-85 |
|--|---------|---------|---------|
| Baseline figures (Cmdnd 8175 revalued and adjusted for gas levy) | 1475 | 511 | 494 |
| <u>1981 IFR</u> (changes since Cmdnd 8175): | | | |
| Capital requirements | +395 | +817 | +1258 |
| Internal resources | -2058 | -2394 | -1719 |
| <u>External finance</u> | +2453 | +3211 | +2977 |

(NOTE: all figures for the external financing of the industries as a whole have been reduced to exclude the effect of the gas levy which, while reducing the British Gas Corporation's internal resources and increasing requirements for external finance and therefore the planning total for all industries, does not affect the size of the PSBR.)

Analysis of Increased Financing Requirement

11. Except for the National Coal Board and British Rail additional finance are made not by the traditional loss-makers but by comparatively profitable industries such as electricity supply, British Gas, BNOG and British Telecom. These industries account for 60-70%* of the additional bids in each year of the IFR. Industries with substantial bids arising mainly from decreases in internal resources include British Rail, British Gas and BNOG. The position is summarised below.

National Coal Board

The Board's medium-term prospectus for 1982-83 onwards was received earlier this month. On the Board's assumptions, the plans show increases in the industry's external financing requirements compared with Cmdnd 8175 of £500m-£700m a year over the IFR period. These figures, and the underlying assumptions, are being discussed with the Board.

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*67% in 1982-83, 62% in 1983-84 and 67% in 1984-85.

Electricity Supply

The main element affecting requirements is an expected sharp decline in internal resources. The industry, having more than achieved the financial target path in 1980-81, is concerned about the possibility of prices rising above economic levels in the later years of the target period against the background of a continuing fall in the expected level of electricity demand. This is being considered in the review of progress against the target which is currently under way. Pending the outcome of that review, the industry has assumed price increases which will maintain the return achieved in 1980-81 (about 1.5%) and which when averaged across the 3 years would fall somewhat short of the existing target. Prices would need to be raised by an additional 4% across the board in April 1982 if the present target is to be achieved, with the danger that prices would exceed the industry's estimate of long-run marginal cost. Moreover planned expenditure on Heysham II is higher than previously expected in the earlier years of construction, though following discussions with the industry capital investment expectations as a whole are almost unchanged.

Scottish Electricity Boards

Internal resources are forecast to be lower than before because of lower sales and smaller tariff increases. In addition there is some increase in investment by the South of Scotland Electricity Board in 1982-83, mainly caused by higher spending on Torness.

British Gas

Excluding the effect of the gas levy, the main factor affecting requirements is a large fall in expected revenues from gas sales. This is primarily the result of the recession in the industrial market. Though a fall in volume is forecast, the main element is the Corporation's assumption of lower price ^{increases} in the industrial market. In addition the cost of gas to the Corporation is likely to be higher than forecast. The Corporation is also proposing a level of investment significantly above the level of figures published in Cmdnd 8175 (although not higher than forecast by the industry in December 1980) in order to improve the supply/demand balance.

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BNOG

Forecast financing surpluses have declined, mainly because of a general reduction in expected North Sea oil production levels. In addition the Corporation's investment programme shows increased expenditure through the period on exploration, and on a range of developments to replace declining production from existing production fields. Almost all of the Corporation's revenues and large parts of its capital expenditures are externally determined.

British Telecom

Substantial increases in investment are planned chiefly as a result of revised estimates of the work required to modernise the network and the costs of introducing new technology. Internal resources are expected to fall as a result of a lower level of tariff increases planned in accordance with the revised financial target.

Post Office

Substantial increases in investment are planned principally to replace existing assets - notably outdated buildings (partly related to the letter mechanisation programme) and for modernising the vehicle fleet to reduce maintenance expenditure. The ending of the Post Office monopoly in certain business areas has led to increased bids for investment in the competitive areas, particularly premium services.

British Rail

The industry has experienced a sharp fall in passenger traffic which, with the continuing depressed state of the freight business has severely worsened its financial position. The prospects for achieving an early improvement in internal resources (as projected in Cmnd 8175) are now remote.

British Shipbuilders

The industry has made a bid for investment, much of it related to the Trident programme which substantially exceeds the notional figures in Cmnd 8175. Financing requirements cannot be settled in advance of decisions in the context of the 1981 Corporate Plan and the Defence Expenditure Review.

12. The remaining industries have made only small bids for additional finance. A number have sharply reduced their projected investment in line with lower revenue forecasts. A reduced financing requirement is shown by British Airways for the whole IFR period, and by British Airports Authority for 1982-83.

13. British Steel Corporation's medium-term plan is still being formulated and is expected in the autumn. In its absence it has been assumed that the Corporation's investments will be restricted to necessary replacement (at existing capacity levels) and participation in joint ventures with the private sector where this will lead to rationalisation of capacity.

Economic Assumptions

14. In accordance with past practice the industries have made their own assumptions about the economy. They are generally more optimistic than the Treasury about economic growth, particularly the Post Office, British Gas, the electricity supply industry and British Airways. Their forecasts of inflation are more pessimistic than the Treasury's working assumptions, although they are generally within the range of outside forecasts. To bring their assumptions into line with Treasury forecasts would on balance be likely to increase still further the bid for additional finance. The industries' assumptions on pay increases are in general linked with their assumptions about inflation. Although pay assumptions have been questioned in the IFR discussions, the general issue of whether to reduce the industries' bids on grounds linked specifically to pay assumptions is best considered when EFLs for 1982-83 are under consideration in the autumn.

Reducing NIs' Contribution to the Planning Total

15. The main options are reducing current costs; increasing tariffs; reducing levels of investment; and increasing disposals (including privatisation):

- 1) Reducing current costs. This is undoubtedly the best option, because it does not simply transfer the burden to the consumer or the Government, and is one where continuing pressure on the industries is required. Although a number of the industries have reduced their manpower there undoubtedly remains

considerable scope for improvements in efficiency, as MMC reports confirm, particularly among the industries insulated from competitive pressure. But it is difficult for Departments to convert these findings into early and quantifiable savings. In addition to increasing competition where possible, by increasing use of MMC and consultancy investigations, the best way of encouraging the industries to reduce current costs is through tight EFLs which can act as stimulants to cost-saving. Performance aims should also help, though progress in introducing them has been slow.

ii) Increasing tariffs. This is a possible course in the case of monopoly industries although Ministers will want to avoid a repetition of 1980-81, when nationalised industry prices increased at about double the rate of the RPI. Some scope for increase remains particularly in domestic gas prices which are still well below economic levels (though the plans already assume a 10% real increase in 1982-83); and possibly in electricity where the industry's performance is forecast to run below present financial targets. However, there have been significant moves to reduce under-pricing over the last two years. Moreover, the fact that the NEDC report demonstrated that certain large UK industrial consumers of energy pay more for energy than some of their competitors abroad makes it difficult to make large increases in this area (though it is less evident that continued restraint in industrial gas prices will be required in later years). For the British Steel Corporation a rise in the general European steel price level is critical in achieving a continuing improvement in financial results. In the case of British Telecom the scope for price increases beyond those already assumed will depend on the Government's decisions on the Beesley report and on whether, in the absence of competition, it would be acceptable to allow prices to the domestic consumer to rise more quickly than the RPI.

iii) Cutting investment. The industries' investment programmes are generally intended to earn a 5% real rate of return: to achieve this individual projects are normally evaluated at

higher discount rates. However investment appraisal by the industries is variable and the result of past investment has frequently been disappointing. Since much of it is to provide increased capacity, for modernisation and quality improvement and for cost-saving, and should in theory lead to better financial performance and improved productivity, substantial cuts are in principle undesirable. At an aggregate level, the investment of the industries had held up well (in contrast to the private sector) and there are few signs that, with some exceptions mainly among the smaller industries (notably National Bus Company and British Transport Docks Board), the industries have thought it necessary to reduce investment in line with falling revenues. In particular there are substantial additions proposed by British Gas, BNOG, British Telecom, Post Office and British Shipbuilders. In discussion between Departments the bids by the Post Office, British Telecom and British Airports Authority have been reduced. In the Treasury's view further action to hold investment at or closer to Cmnd 8175 levels could be taken by BNOG, BGC, and the Post Office (although at the price of deferring the benefits of increased mechanisation) and by British Telecom by lower levels of investment in areas not directly related to mechanisation and by slowing the planned growth in the network while still allowing modernisation to go ahead to plan. The industries have already had approval for up to 85% of the investment programmes set out in Cmnd 8175 (Table 3.2) but in principle investment could be held at this level.

iv) Disposals & privatisation. The figures for each industry take no account of the possibility of full privatisation i.e. flotation; disposals counting towards special sales of assets; or introduction of private capital in joint ventures or subsidiaries. Moves of this kind would help to reduce the PSBR directly (by contributing to the disposals target) but might in particular cases make the industry's financing position worse by depriving them of profitable activities. Alternatively the industry might retain a share of the proceeds which would reduce future financing requirements. However any

considerable scope for improvements in efficiency, as MMC reports confirm, particularly among the industries insulated from competitive pressure. But it is difficult for Department to convert these findings into early and quantifiable savings. In addition to increasing competition where possible, by increasing use of MMC and consultancy investigations, the best way of encouraging the industries to reduce current costs is through tight EFLs which can act as stimulants to cost-saving. Performance aims should also help, though progress in introducing them has been slow.

ii) Increasing tariffs. This is a possible course in the case of monopoly industries although Ministers will want to avoid a repetition of 1980-81, when nationalised industry prices increased at about double the rate of the RPI. Some scope for increase remains particularly in domestic gas prices which are still well below economic levels (though the plans already assume a 10% real increase in 1982-83); and possibly in electricity where the industry's performance is forecast to run below present financial targets. However, there have been significant moves to reduce under-pricing over the last two years. Moreover, the fact that the NEDC report demonstrated that certain large UK industrial consumers of energy pay more for energy than some of their competitors abroad makes it difficult to make large increases in this area (though it is less evident that continued restraint in industrial gas prices will be required in later years). For the British Steel Corporation a rise in the general European steel price level is critical in achieving a continuing improvement in financial results. In the case of British Telecom the scope for price increases beyond those already assumed will depend on the Government's decisions on the Beesley report and on whether, in the absence of competition, it would be acceptable to allow prices to the domestic consumer to rise more quickly than the RPI.

iii) Cutting investment. The industries' investment programmes are generally intended to earn a 5% real rate of return: to achieve this individual projects are normally evaluated at

higher discount rates. However investment appraisal by the industries is variable and the result of past investment has frequently been disappointing. Since much of it is to provide increased capacity, for modernisation and quality improvement and for cost-saving, and should in theory lead to better financial performance and improved productivity, substantial cuts are in principle undesirable. At an aggregate level, the investment of the industries had held up well (in contrast to the private sector) and there are few signs that, with some exceptions mainly among the smaller industries (notably National Bus Company and British Transport Docks Board), the industries have thought it necessary to reduce investment in line with falling revenues. In particular there are substantial additions proposed by British Gas, ENOC, British Telecom, Post Office and British Shipbuilders. In discussion between Departments the bids by the Post Office, British Telecom and British Airports Authority have been reduced. In the Treasury's view further action to hold investment at or closer to Cmnd 8175 levels could be taken by ENOC, BGC, and the Post Office (although at the price of deferring the benefits of increased mechanisation) and by British Telecom by lower levels of investment in areas not directly related to mechanisation and by slowing the planned growth in the network while still allowing modernisation to go ahead to plan. The industries have already had approval for up to 85% of the investment programmes set out in Cmnd 8175 (Table 3.2) but in principle investment could be held at this level.

iv) Disposals & privatisation. The figures for each industry take no account of the possibility of full privatisation i.e. flotation; disposals counting towards special sales of assets; or introduction of private capital in joint ventures or subsidiaries. Moves of this kind would help to reduce the PSBR directly (by contributing to the disposals target) but might in particular cases make the industry's financing position worse by depriving them of profitable activities. Alternatively the industry might retain a share of the proceeds which would reduce future financing requirements. However any

arrangement allowing the industry to retain all or part of the proceeds of disposals should not be allowed to weaken the discipline imposed by the EFL. In practice those industries which are candidates for early privatisation (BNOC, National Freight Company, British Transport Docks Board) are not significant net borrowers. There is some scope for future disposals (British Rail) and for joint ventures (British Telecom, British Steel Corporation). In the case of British Telecom the figures included in the IFR already allow for some revenue from privatisation in 1983-84 and 1984-85.

16. Against the background of the Government's stated wish to reduce expenditure totals, the scale of the industries' additional financing bids poses especially serious - indeed in the Treasury's view unacceptable - problems. Ministers will need to consider how far it is possible to hold the industries' requirements for finance to levels much nearer those set out in Cmnd 8175. To this end Treasury officials consider that there are further actions by the industries (mainly lower levels of investment or tariff increases) which will need to be seriously considered.

Conclusion

17. Ministers are invited:

- i) to note the threat to the public expenditure totals in Cmnd 8175 as a result of the revised financing requirements of the nationalised industries;
- ii) to decide how far it is possible to hold these requirements at or close to Cmnd 8175 levels and the basis on which this should be done;
- iii) in the light of decisions on (ii):
 - a) to approve on a provisional basis the financing requirements of the individual industries as a basis for setting EFLs for 1982-83 in the autumn; and to agree figures for the later years as an input into the next public expenditure White Paper;
 - b) to agree the investment totals for the industries for all 3 years of the IFR (although authority would be limited

- to 85% and 70% for the two later years);
- iv) to agree that in the case of the National Coal Board the EFL for 1982-83, the financing requirements for the later years and the investment plans should be considered separately.

1981 INVESTMENT AND FINANCING REVIEW

Capital Requirements Internal Resources and External Finance : Changes on Cmd 8175

| | Capital Requirements | | | Internal Resources | | | External Finance | | |
|--|----------------------|--------------|---------------|--------------------|---------------|---------------|------------------|---------------|---------------|
| | 1982-83 | 1983-84 | 1984-85 | 1982-83 | 1983-84 | 1984-85 | 1982-83 | 1983-84 | 1984-85 |
| National Coal Board ^a | - 55 | + 62 | - 5 | - 598 | - 702 | - 651 | + 543 | + 764 | + 646 |
| Electricity Supply Industry (England and Wales) | - 22 | + 8 | + 233 | - 293 | - 292 | - 103 | + 271 | + 300 | + 336 |
| North of Scotland Hydro- Electric Board | + 16 | + 7 | + 11 | - 10 | - 15 | - 17 | + 26 | + 22 | + 28 |
| South of Scotland Electricity Board | + 27 | + 10 | - 45 | - 43 | - 56 | - 73 | + 70 | + 66 | + 28 |
| British Gas Corporation | + 138 | + 141 | + 112 | - 914 | - 1060 | - 960 | + 1052 | + 1201 | + 1072 |
| British National Oil Corporation | + 50 | + 91 | + 237 | - 150 | - 192 | - 182 | + 201 | + 283 | + 419 |
| British Steel Corporation ^b | 0 | 0 | 0 | + 36 | - 89 | - 76 | - 36 | + 89 | + 76 |
| British Telecom | + 192 | + 389 | + 608 | - 293 | - 189 | - 62 | + 485 | + 577 | + 545 |
| Post Office (Postal) | + 63 | + 43 | + 46 | + 22 | + 36 | + 42 | + 42 | + 7 | + 2 |
| National Girobank | - 2 | - 6 | - 4 | - 3 | - 4 | - 2 | - 47 | - 1 | 0 |
| British Airways | - 6 | - 14 | - 11 | + 41 | + 18 | + 55 | - 47 | - 32 | - 66 |
| British Airports Authority | - 10 | + 47 | + 43 | + 1 | + 9 | + 27 | - 11 | + 37 | + 16 |
| British Railway Board | - 13 | - 29 | - 17 | - 239 | - 264 | - 279 | + 226 | + 235 | + 263 |
| British Transport Docks Board | - 9 | - 9 | - 9 | - 13 | - 12 | - 11 | + 3 | + 3 | + 2 |
| British Waterways Board | + 4 | + 4 | + 5 | - 4 | - 6 | - 5 | + 9 | + 9 | + 10 |
| National Freight Company | - 15 | - 11 | - 9 | - 17 | - 14 | - 14 | + 1 | + 4 | + 6 |
| National Bus Company | - 24 | - 18 | - 12 | - 30 | - 24 | - 12 | + 6 | + 6 | 0 |
| Scottish Transport Group | 0 | - 1 | - 3 | - 9 | - 13 | - 15 | + 9 | + 12 | + 12 |
| British Shipbuilders | + 60 | + 102 | + 78 | + 3 | + 21 | + 48 | + 58 | + 81 | + 30 |
| TOTAL : ALL INDUSTRIES (including gas levy) | + 395 | + 817 | + 1258 | - 2513 | - 2848 | - 2166 | + 2908 | + 3665 | + 3424 |
| Less Effects of gas levy | - | - | - | - 455 | - 454 | - 447 | 455 | 454 | 447 |
| TOTAL : ALL INDUSTRIES (excluding gas levy) | + 395 | + 817 | + 1258 | - 2058 | - 2394 | - 1719 | + 2453 | + 3211 | + 2977 |

Notes

- a. Figures for NCB are provisional.
 b. Figures for BSC are based on an assumed external financing requirement of £350m in each of the three years. The changes that this represents on the external financing figures assumed in Cmd 8175 (of -£36m, +£89m and +£76m) have all been allocated to internal resources.

NATIONALISED INDUSTRIES - FINANCING OF CAPITAL REQUIREMENTS

£ million cash terms

| | 1976-77 | 1977-78 | 1978-79 | 1979-80 | 1980-81 | 1981-82 | 1982-83 | 1983-84 | 1984-85 |
|--|---------|---------|---------|---------|---------|---------|---------|---------|---------|
| Government lending(net) | | | | | | | | | |
| Loans | -216 | -700 | -171 | 673 | 770 | 1,293 | 1,017 | 776 | 762 |
| FDC and issues under Section 18 of the Iron and Steel Act 1975 | 500 | 482 | 864 | 1,184 | 1,353 | 824 | 610 | 627 | 610 |
| Total | 284 | -218 | 693 | 1,857 | 2,123 | 2,117 | 1,627 | 1,403 | 1,372 |
| Overseas and market borrowing (net) | | | | | | | | | |
| Overseas | 1,346 | 456 | 82 | -285 | -142 | -287 | 89 | 346 | 273 |
| Market | -95 | - | 9 | -747 | -122 | 18 | 23 | 67 | -45 |
| Short-term borrowing and leasing | 17 | 468 | 355 | 701 | -97 | 131 | 429 | 76 | -2 |
| Total | 1,268 | 924 | 446 | -331 | -361 | -138 | 541 | 489 | 226 |
| Total net borrowing | 1,552 | 706 | 1,139 | 1,526 | 1,762 | 1,979 | 2,168 | 1,892 | 1,598 |
| Grants | 691 | 710 | 881 | 1,087 | 1,092 | 1,531 | 1,760 | 1,829 | 1,876 |
| Total external finance | 2,243 | 1,416 | 2,020 | 2,613 | 2,854 | 3,510 | 3,928 | 3,721 | 3,474 |
| Total internal resources | 2,139 | 2,146 | 2,436 | 1,927 | 2,713 | 3,425 | 4,899 | 6,028 | 7,160 |
| Total capital requirements | 4,382 | 3,562 | 4,456 | 4,540 | 5,567 | 6,935 | 8,827 | 9,749 | 10,634 |

Note (i) For the purpose of constructing aggregate figures, it has been assumed that, for NCB and BRB, total net borrowing is allocated between categories in the same proportions as in Cmnd 8175; and that, for BSC, the changes since Cmnd 8175 implied by the working assumption of a £350m external financing figure in each year have all been met by adjustments in Section 18 issues.

- (ii) The figures for total capital requirements in 1982-83, 1983-84, and 1984-85 are before allowing for shortfall. The shortfall of £500m a year in Cmnd 8175 (1980 Survey Prices) would imply respective reductions of £703m, £745m and £782m, bringing the totals to £8,124m, £9,004m, and £9,852m.

CONFIDENTIAL

£ million (cash terms)

| | 1976-77 | 1977-78 | 1978-79 | 1979-80 | 1980-81 | 1981-82 | 1982-83 | 1983-84 | 1984-85 |
|--|---------|---------|---------|---------|---------|---------|---------|---------|---------|
| Expenditure on fixed assets in the UK | | | | | | | | | |
| National Coal Board | 300 | 364 | 495 | 665 | 810 | 805 | 1,022 | 1,133 | 1,270 |
| Electricity Council and Boards | 704 | 671 | 715 | 834 | 982 | 1,197 | 1,419 | 1,584 | 1,850 |
| North of Scotland Hydro-Electric Board | 76 | 63 | 48 | 46 | 43 | 45 | 56 | 52 | 57 |
| South of Scotland Electricity Board | 56 | 43 | 53 | 65 | 132 | 239 | 421 | 434 | 403 |
| British Gas Corporation | 271 | 235 | 280 | 402 | 568 | 685 | 989 | 1,041 | 991 |
| British National Oil Corporation | 160 | 206 | 243 | 218 | 212 | 363 | 454 | 503 | 670 |
| British Steel Corporation | 596 | 502 | 334 | 289 | 178 | 198 | - | - | - |
| British Telecom | 816 | 844 | 993 | 1,215 | 1,548 | 1,927 | 2,537 | 2,977 | 3,261 |
| Post Office | 39 | 35 | 42 | 64 | 76 | 135 | 170 | 156 | 164 |
| Girobank | - | 1 | 5 | 5 | 8 | 12 | 10 | 6 | 6 |
| British Airways Board | 156 | 202 | 219 | 289 | 276 | 205 | 249 | 348 | 367 |
| British Airports Authority | 42 | 37 | 33 | 54 | 79 | 106 | 167 | 190 | 221 |
| British Railways Board | 248 | 276 | 349 | 381 | 334 | 348 | 455 | 540 | 600 |
| British Transport Docks Board | 8 | 10 | 9 | 13 | 10 | 11 | 115 | 17 | 19 |
| British Waterways Board | 2 | 2 | 2 | 4 | 6 | 7 | 7 | 8 | 9 |
| National Freight Company | 23 | 30 | 36 | 35 | 36 | 43 | 45 | 48 | 53 |
| National Bus Company | 40 | 46 | 54 | 60 | 64 | 54 | 66 | 81 | 91 |
| Scottish Transport Group | 10 | 10 | 17 | 16 | 16 | 14 | 14 | 15 | 14 |
| British Aerospace | | 19 | 26 | 42 | 56 | - | - | - | - |
| British Shipbuilders | | 20 | 27 | 18 | 18 | 39 | 60 | 92 | 120 |
| Total expenditure on fixed assets | 3,546 | 3,616 | 3,980 | 4,715 | 5,452 | 6,428 | 8,156 | 9,225 | 10,166 |
| Other capital requirements | 837 | - 55 | 476 | - 175 | 115 | 507 | 671 | 524 | 768 |
| Shortfall | - | - | - | - | - | - | -703 | -745 | -782 |
| Total capital requirements (after shortfall) | 4,383 | 3,562 | 4,456 | 4,540 | 5,567 | 6,939 | 8,124 | 9,004 | 9,852 |
| Change on Cmd 8175 | - | - | - | - | -19 | -149 | +394 | +815 | +1253 |

Note As a working assumption, BSC figures are those implied by Cmd 8175

NATIONALISED INDUSTRIES : TOTAL NET BORROWING AND LEASING

| | £million cash terms | | | | | |
|--|---------------------|--------------|--------------|--------------|--------------|--------------|
| | 1979-80 | 1980-81 | 1981-82 | 1982-83 | 1983-84 | 1984-85 |
| National Coal Board | 407 | 581 | 571 | 706 | 798 | 732 |
| Electricity Council and Boards | 184 | 132 | -174 | -231 | -350 | -346 |
| North of Scotland Hydro-Electric Board | 48 | 26 | 18 | 43 | 35 | 40 |
| South of Scotland Electricity Board | 55 | 32 | 77 | 265 | 280 | 242 |
| British Gas Corporation | -447 | 400 | 116 | 192 | -60 | -252 |
| British National Oil Corporation | -27 | -217 | -221 | -60 | -62 | 57 |
| British Steel Corporation | 579 | 1,119 | 730 | 350* | 350* | 350* |
| British Telecom | 270 | -109 | 500 | 516 | 543 | 509 |
| Post Office | -33 | -6 | 11 | 27 | -8 | -13 |
| Girobank | 3 | 4 | 12 | 4 | - | -1 |
| British Airways Board | 171 | 304 | 101 | 86 | 124 | 99 |
| British Airports Authority | -1 | 18 | 13 | 61 | 55 | 35 |
| British Railways Board | 27 | 121 | 125 | 94 | 63 | 48 |
| British Transport Docks Board | -7 | 1 | -5 | -5 | -5 | -6 |
| British Waterways Board | 3 | 4 | 3 | 6 | 7 | 7 |
| National Freight Company | 17 | 6 | 3 | -2 | - | 2 |
| National Bus Company | 20 | 19 | 15 | 24 | 25 | 23 |
| Scottish Transport Group | -2 | -9 | -4 | -1 | - | -2 |
| British Aerospace | 53 | -3 | - | - | - | - |
| British Shipbuilders | 205 | 139 | 89 | 92 | 99 | 74 |
| Total | 1,526 | 1,762 | 1,980 | 2,168 | 1,892 | 1,598 |
| Change on Cmnd 8175 | - | -47 | +936 | +2272 | +3115 | +2775 |

See footnote in Appendix B BSC text.

NATIONALISED INDUSTRIES : GRANTS

| | £million cash terms | | | | | |
|--|---------------------|--------------|--------------|-------------|-------------|-------------|
| | 1979-80 | 1980-81 | 1981-82 | 1982-83 | 1983-84 | 1984-85 |
| National Coal Board | 244 | 243 | 546 | 614 | 606 | 586 |
| Electricity Council and Boards | 5 | 8 | 9 | 12 | 11 | 11 |
| North of Scotland Hydro-Electric Board | 11 | 16 | 14 | 8 | 9 | 8 |
| South of Scotland Electricity Board | - | - | - | - | - | - |
| British Gas Corporation | - | - | - | - | - | - |
| British National Oil Corporation | - | - | - | - | - | - |
| British Steel Corporation | - | - | - | - | - | - |
| British Telecom | - | - | - | - | - | - |
| Post Office | - | - | - | - | - | - |
| Girobank | - | - | - | - | - | - |
| British Airways Board | - | - | - | - | - | - |
| British Airports Authority | 1 | - | 1 | - | - | - |
| British Railways Board | 687 | 669 | 787 | 950 | 1034 | 1120 |
| British Transport Docks Board | - | - | - | - | - | - |
| British Waterways Board | 23 | 26 | 28 | 34 | 37 | 39 |
| National Freight Company | 11 | 5 | 3 | 2 | 2 | 2 |
| National Bus Company | 60 | 66 | 60 | 58 | 64 | 64 |
| Scottish Transport Group | 14 | 21 | 20 | 27 | 29 | 32 |
| British Aerospace | - | - | - | - | - | - |
| British Shipbuilders | 31 | 39 | 62 | 55 | 37 | 14 |
| TOTAL | 1,087 | 1,092 | 1,530 | 1760 | 1829 | 1876 |
| Change on Cmnd 8175 | - | -10 | +302 | +636 | +708 | +699 |

NATIONALISED INDUSTRIES' INVESTMENT AND
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APPENDIX B : INDIVIDUAL INDUSTRY ANNEXES

| Section number | Industry | 1981-82 | 1982-83 | 1983-84 | 1984-85 |
|----------------|--|---------|---------|-----------|---------|
| 1 | NATIONAL COAL BOARD | | | | |
| 2 | ELECTRICITY COUNCIL AND BOARDS | | | | |
| 3 | NORTH OF SCOTLAND HYDRO-ELECTRIC BOARD | | | | |
| 4 | SOUTH OF SCOTLAND ELECTRICITY BOARD | | | 1133(+49) | 1274 |
| 5 | BRITISH GAS CORPORATION | | | 371(+12) | -114 |
| 6 | BRITISH NATIONAL OIL CORPORATION | | | 1164(+62) | 1152 |
| 7 | BRITISH STEEL CORPORATION | | | | |
| 8 | BRITISH TELECOM | | | -240(-73) | -166 |
| 9 | POST OFFICE | | | 506(+132) | 506 |
| 10 | NATIONAL GIROBANK | | | | |
| 11 | BRITISH AIRWAYS BOARD | | | | |
| 12 | BRITISH AIRPORTS AUTHORITY | | | 703(+27) | 751 |
| 13 | BRITISH RAILWAYS BOARD | | | | |
| 14 | BRITISH TRANSPORT DOCKS BOARD | | | | |
| 15 | BRITISH WATERWAYS BOARD | | | | |
| 16 | NATIONAL FREIGHT COMPANY | | | 122(+104) | 1312 |
| 17 | NATIONAL BUS COMPANY | | | | |
| 18 | SCOTTISH TRANSPORT GROUP | | | | |
| 19 | BRITISH SHIPBUILDERS | | | | |

1. NATIONAL COAL BOARD

Table B.1.1

| | £ million estimated outturn prices (Change on Cmnd 8175 in brackets) | | | |
|--|---|------------|------------|---------|
| | 1981-82 | 1982-83 | 1983-84 | 1984-85 |
| <u>Capital Requirements</u> | | | | |
| 1. Fixed assets in UK | 805(-83) | 1022(+25) | 1133(+49) | 1270 |
| 2. Other | 12(+41) | -4(-80) | 31(+13) | -118 |
| TOTAL (1+2) | 817(-42) | 1018(-55) | 1164(+62) | 1152 |
| <u>Financed by</u> | | | | |
| 3. Internal resources | -300(-273) | -302(-598) | -240(-702) | -166 |
| 4. Grants | 546(+279) | 614(+458) | 606(+492) | 586 |
| 5. Leasing | 8(+1) | | | |
| 6. Short-term borrowing | -(-42) | 706(+85) | 798(+272) | 732 |
| 7. Long and medium term borrowing | 563(-7) | | | |
| <u>Total external finance</u> (4+5+6+7) | 1117(+231) | 1320(+543) | 1404(+764) | 1318 |

The Board's external finance requirement for 1980-81 was £884 million, £52 million more than their EFL of £832 million. A major reason for the excess was higher stockbuilding because of lower than expected sales combined with high output. In an effort to keep within their EFL, the Board increased exports to 4.7 mt compared with 2.5 mt in 1979-80 but stocks still rose by 9 mt.

2. The Secretary of State for Energy announced on 16 June the outcome of his review of the NCB's financial position for 1981-82 following the withdrawal in February of the Board's accelerated pit closure plans and the decision to reduce coal imports to minimum practicable levels. The previously announced EFL of £886 million has been raised to £1,117 million. Within this sum, grants to offset the Board's revenue losses will be some £450 million, in addition to social grants of some £100 million.

3. The NCB's medium-term prospectus for 1982-83 onwards was received at the end of the first week in July. The bids for external finance over the IFR period are between £500 million-£750 million above Cmnd 8175 revalued in each year. The figures and the underlying assumptions are now being discussed with the Board and are highly provisional.

2. ELECTRICITY (ENGLAND AND WALES)

Table B.2.1

| | £ million estimated outturn prices (Change on Cmnd 8175 in brackets) | | | |
|--|---|------------|------------|-------------|
| | 1981-82 | 1982-83 | 1983-84 | 1984-85 |
| <u>Capital Requirements</u> | | | | |
| 1. Fixed assets in UK | 1197(-24) | 1419(+101) | 1584(+128) | 1850 |
| 2. Other | 28(+22) | 88(-123) | 87(-120) | 130 |
| TOTAL (1+2) | 1225(-2) | 1507(-22) | 1671(+8) | 1980 |
| <u>Financed by</u> | | | | |
| 3. Internal resources | 1390(-47) | 1726(-293) | 2010(-292) | 2315 |
| 4. Grants | 9(-1) | 12(-) | 11(-3) | 11 |
| 5. Leasing | 43(+3) | 32(-12) | 43(+1) | 33 |
| 6. Short-term borrowing | -93(-) | 36(+40) | -54(-58) | -9 |
| 7. Long and medium term borrowing | -124(+43) | -238(+303) | -229(+470) | -370 |
| <u>Total external finance</u> | | | | |
| (4+5+6+7) | -165 ⁽¹⁾ (+45) | -219(+270) | -339(+300) | -335 |
| 8. Industries general inflation assumption (%) | 13 | 10 | 10 | 10 |
| (Change on Cmnd 8175 attributable to this) | - | (-21) | (-48) | - |
| <u>MEMORANDUM</u> | | | | |
| 9. Assumed increase in paybill (%) | 8.2 | 8.9 | 8.3 | 8.4 |
| 10. Assumed increase in tariff (%) | 13 | 12 | 13 | 12 |
| 11. Performance against target(2) | | | | |
| Target path: | 2.0 | 2.5 | - | No target - |
| Latest forecast: | 1.35 | 1.6 | 1.6 | 1.6 |

Notes

- (1) A change in the EFL for 1981-82 from -£210m to -£165m was announced in the Budget
- (2) Target is for average rate of return of 1.8% on net assets valued at current cost over the 3 years 1980-81 to 1982-83. Performance in 1980-81 was above the target path: a 1.65% rate return against target path of 0.9%.

Outlook/market prospects

Estimates of the demand for electricity have fallen since last year, and in the early years of the Review are some 4 per cent lower than those underlying last year's IFR. Currently, the industry are expecting the recession to bottom out later this year and are forecasting an increase in demand of just under 1 per cent in 1981-82 compared with 1980-81. Electricity demand is forecast to increase by the end of their seven year planning period roughly to levels estimated last year. There are obvious uncertainties here, and the estimates are being kept under review with the Electricity Council.

2. Against this background of lower than expected demand, together with changes in cost assumptions, the electricity supply industry is reviewing prospects for achievement of its financial target agreed in early 1980 (an average annual rate of return of 1.8 per cent over three years on net assets valued at current cost). The results of these studies are expected towards the end of the year.

3. The industry has been the subject of two major reports since the last Review. In February 1981, the Select Committee on Energy reported on "The Government's statement on the new nuclear power programme"; a reply is being prepared. The generation and transmission of bulk supplies of electricity by the CEBG was the subject of an investigation by the MMC published in May 1981; the Commission's findings and recommendations are being studied by the Department. The Secretary of State had asked the Electricity Council in July 1980 to undertake a review of the industry's Bulk Supply Tariff taking into account the views of major consumers; this should be completed by the end of the year.

Investment plans

4. The esi's investment in fixed assets in the UK is estimated to rise from £1,197 million (outturn) in 1981-82 (or £1,097 million at constant average 1980-81 prices) to £1,850 million in 1984-85 (£1,217 million, constant prices).

5. Some three-quarters of the industry's investment is accounted for by the CEBG, and three-quarters of this is for main generating plant. A large proportion of this, and highest in the early years of the Review, is for the completion of stations already under construction, viz:

Table B.2.2

| | % | |
|------------------------------------|----------------|----------------|
| | <u>1982-83</u> | <u>1983-84</u> |
| stations close to completion | 25 | 10 |
| Drax | 19 | 15 |
| Heysham II | 34 | 36 |
| Total, stations under construction | <hr/> 78 | <hr/> 61 |

6. Decisions on this plant have already been taken (in some cases many years ago), and the stations need to be commissioned as soon as possible to achieve economic benefit. Ministers decided over a year ago that Heysham II - which accounts for one-third of the Board's investment in 1982-84 - should proceed, on the grounds that it was expected ultimately to result in a reduction in the industry's costs, and for wider industrial and energy policy reasons. The CEGB's programme also includes provision for a Cross Channel Link with Electricite de France. This is justified on grounds of cost reduction (primarily from energy trading, but also from the advanced retirement of old plant). Ministers agreed to investment approval in July 1980, on condition that the capital cost was met from savings elsewhere in the programme. To meet this condition, the industry have deferred plans for the replanting of the coal station at Drakelow; in addition, for 1984-85, adjustments have been made to the proposals for nuclear stations after Sizewell.

7. CEGB expenditure on transmission projects accounts for 10-15 per cent of the Board's expenditure. This is required to meet the changing pattern of demand and to ensure a secure system of supply. The changing pattern as older stations are retired and new ones commissioned is also relevant.

8. Some 40-50 per cent of investment by the Area Electricity Boards is for new business which the Boards are statutorily required to supply and to which consumers contribute a proportion of the costs. A further 35 per cent is for reinforcement of the existing system to ensure safety and security of supply. Closure of CEGB power stations is one of the main reasons why this expenditure is needed.

9. The further reduction in the demand for electricity now forecast for the early 1980's means that the industry may need to take steps to keep its plant margin down in line with the planning margin of 28 per cent. The CEGB has some flexibility in dealing with the problem of excess capacity and uncertainties in the load forecast through the ability to vary the rate at which older plant is taken off the system. In the autumn of 1981, the Board will be withdrawing 3.4 GW of plant from the system; and up to a further 3 GW could be withdrawn in the following year. On current estimates, the plant margin should be close to 28 per cent by 1987-88:

Table B.2.3

| | 1987-88 | 1988-89 |
|--|---------|---------|
| demand to be supplied from CEGB plant (GW) | 45.5 | 46.4 |
| maximum output capacity (GW) | 58.8 | 59.4 |
| plant margin (%) | 29 | 29 |

10. In their original IFR return, the esi estimated that their capital investment would be £1481 million (outturn) in 1982-83 and £1694 million in 1983-84. This represented an increase in expenditure when compared with Cmnd 8175, and was due to increased requirements of £120 million and £110 million respectively by the CEGB (industry's outturn; £102 million and £86 million at constant March 1981 prices). These increases were partly offset by reductions of £46 million and £35 million by the Electricity Boards (£39 million and £27 million at March 1981 prices). The increases primarily reflect a changed incidence of expenditure for Heysham II following the outcome of detailed contractual negotiations with plant manufacturers (the CEGB advise that there will be consequential reductions in the later years of the station's construction), together with an estimated increase in spend in 1982-83 on stations currently under construction.

11. Officials have discussed with the CEGB the scope for reducing the Board's capital expenditure on 1982-83 and 1983-84, and have identified the following possible savings:

| | 1982-83 | 1983-84 |
|--|---------|---------|
| slippage in PWR timetable | 15(13) | 51(40) |
| fast reactor collaboration | 6(5) | 6(5) |
| reductions in transmission and miscellaneous expenditure | 40(34) | 53(41) |
| | 61(52) | 110(86) |

- (i) reductions in PWR expenditure are the result of an assumed slippage of 5-6 months in the PWR timetable. The timetable is, however, still uncertain, and the Department of Energy wish to reserve the position of Energy Ministers on the PWR pending further advice from the nuclear industry;
- (ii) because of the highly uncertain situation over fast reactor collaboration, the provision of £6 million annually has been excluded; it is unlikely to be needed in the near future;
- (iii) the remainder of the reductions come from reductions in the industry's transmission expenditure (primarily reinforcement of bulk supply points); from deferment of expenditure on the re-boiling of Drakelow C and a coal import facility; and from global reductions in the Board's miscellaneous capital expenditure, where specific projects to be cut have yet to be identified.

12. The CEGB's programme is dominated by a small number of very large capital projects, and the scope for making reductions here at times of constraints on capital is small. Over the last 2-3 years, pressures have increased on the industry to cut back on capital

investment, and these have effectively meant that it has been smaller projects which have been squeezed. The cuts outlined above in the Board's programme of miscellaneous capital projects have further tightened the squeeze, and any further cutback would be likely, they say, to result in the dropping of schemes which are required to have a payback within three years of commissioning using a 15 per cent test discount rate. Further reduction in transmission schemes could probably be achieved only by deferring the Board's plant closure programme (and thus foregoing the associated savings) or through accepting lower levels of supply security.

13. The net effect of the measures listed in paragraph 11 is to reduce the CEGB's capital expenditure by £61 million and £110 million (outturn). Taking into account reductions in Area Boards' Capital spend, the esi's total capital investment, when compared with Cmnd 8175, would be increased by £13 million in 1982-83 but reduced by £35 million in 1983-84 (£11 million and £27 million in March 1981 prices). These figures - which have not been agreed with the Electricity Council - have been included in the industry's bids discussed below. (Consequential effects for 1984-85 have not been discussed with the industry; figures for that year therefore reflect their original IFR return).

Financing

14. The esi's EFL for 1980-81 was set at £187 million. Final outturn - at £140 million - was £47 million within the limit, primarily because tariff increases to quarterly billed (mainly domestic) consumers were based on a forecast fuel price which in the event proved to be too high. The return on net assets is estimated to have been 1.65 per cent (compared to 0.9 per cent planned when the financial target was set in January 1980) but with lower sales (down 7 per cent on target assumptions), lower costs (down 4 per cent), and lower income (down 3 per cent).

15. The industry has agreed to use its best endeavours to meet its EFL of -£165 million for 1981-82 (reduced from -£210 million, the difference to be used to lower tariffs for large industrial consumers). This intent has yet to be translated into figures for action in specific areas; thus for IFR purposes an adjustment has been made to debtors less creditors.

16. The industry's figures for external financing requirements for the years beyond 1981-82 are:

Table B.2.5

| | £ million estimated outturn | | |
|--|-----------------------------|---------|---------|
| | 1982-83 | 1983-84 | 1984-85 |
| Cmnd 8175 (revalued) | | | |
| (using PESC (81) 7 assumptions) | -489 | -639 | -671* |
| Industry's bid as modified (see para 12) | -219 | -339 | -335 |
| Increase over Cmnd 8175 revalued | +270 | +300 | +336* |

* Represents 1983-84 baseline revalued by 5 per cent

17. The industry's figures show a significant reduction, from 1982-83 onwards, in the level of forecast net repayments over those implied by Cmnd 8175. This is due to three factors:

- (i) pending the outcome of the industry's studies on the financial target, the esi are assuming for planning purposes the following rates of return:

Table B.2.6

| % return | 1980-81 | 1981-82 | 1982-83 | 1983-84 |
|---------------------|---------|---------|---------|---------|
| current assumptions | 1.65 | 1.35 | 1.6 | 1.6 |
| original target | 0.9 | 2.0 | 2.5 | - |

These rates of return are based on the following assumptions:

| | 1981-82 | 1982-83 | 1983-84 | 1984-85 |
|----------------------|---------|---------|---------|---------|
| prices, % | 13 | 12 | 13 | 12 |
| general inflation, % | 13 | 10 | 10 | 10 |

One effect of the lower rates of return is the lower level of internal resources now expected by the Council. However, the industry are concerned that prices should not rise above economic levels: indications are that prices rose towards economic levels considerably faster last year than had been assumed in the target discussions. According to the MMC report, a recent calculation by the CEGB indicates that the current bulk supply tariff now reflects the Board's interpretation of long-run marginal costs. The existing 3-year target could, on the price increases above, only be achieved by a further increase of about 4 per cent in April 1983 in addition to those indicated above.

- (ii) The continuing fall in the expected level of electricity demand. However, demand could well turn out to be even lower than the industry are forecasting.

The effect of a 1 per cent fall in demand is to increase the industry's external financing requirements by:

| | 1981-82 | 1982-83 | 1983-84 | 1984-85 |
|----------------|---------|---------|---------|---------|
| £m | 20-60 | 25-80 | 30-1000 | 40-120 |
| outturn prices | | | | |

(The lower end of the ranges assumes that the change is perceived in time for the industry to reduce its fuel purchases.)

18. On current estimates, the esi plan to make the following net repayments:

Table B.2.8

| | (£m, outturn prices) | | | |
|--------------|----------------------|---------|---------|---------|
| | 1981-82 | 1982-83 | 1983-84 | 1984-85 |
| Foreign debt | 121 | 49 | 22 | 27 |
| NLF debt | 6 | 189 | 208 | 333 |

Financing constraints

19. The Department of Energy consider that the electricity supply industry has experienced, over the past 2-3 years, considerable pressure to cut back not only its investment but also its other operating costs, and that the scope for further reductions in the industry's financing requirements is very limited. As regards capital expenditure, a large proportion (see paragraph 5) of the CEBG's capital investment programme is for large power station projects which have already started, which have binding contractual commitments, and which should be completed as soon as possible for the achievement of maximum economic benefit. In addition, the Board are asking for extra capital in 1982-84 to meet the changed incidence of expenditure on Heysham II, a project to which they attach high priority. Constraints on capital spending would therefore fall on the many small projects which, however, make up only a small proportion of the Board's investment. Reductions here could ultimately affect the reliability of plant operation. The Area Electricity Boards have already reduced their capital programmes for 1982-84, and the scope for further cuts is, in the Department's view, very small if the safety and security of supply is not to be impaired, and the statutory obligation to supply new consumers is to be fulfilled.

20. As regards current costs, the industry's fuel stocking assumptions are regarded as reasonable; attempts to reduce the level of stocks would have implications for security of supply. The industry is undertaking programmes to minimise its operating costs, and the effects of these are reflected in the IFR return. The CEBG's manpower, for example, was reduced by some 4 per cent in 1980-81, and there are plans for further reductions. Plant repair and maintenance programmes have been reduced. Many of these reductions have been achieved at the cost of reduced security of supply, and the Department of Energy consider that further cuts would bring greater risk of plant breakdown.

21. The options for reductions are as follows:

- (i) Higher tariffs.

The industry are concerned that any further tariff increases above those in paragraph 16 might take prices above economic levels. However, an additional 1 per cent and 5 per cent on tariff increases each year would reduce the industry's external financing requirements by:

Table B.2.9

| | £ million outturn prices | | |
|---------------|--------------------------|---------|---------|
| | 1982-83 | 1983-84 | 1984-85 |
| extra 1% p.a. | 45 | 102 | 180 |
| extra 5% p.a. | 217 | 494 | 847 |

(Note: Figures assume that each 1 per cent increase causes 0.3 per cent decline in demand. No allowance has been made for any consequential reduction in the industry's fuel purchases).

- (ii) Stopping work on the Isle of Grain Power Station

The CEBG have advised that stopping work on Grain would result in savings of about 50 per cent of planned future expenditure after deducting compensation payments etc. The savings could be of the following order, but accurate figures would have to await further discussion with the Board:

Table B.2.10

| | £ million | | |
|---------------------|-----------|---------|---------|
| | 1982-83 | 1983-84 | 1984-85 |
| Outturn prices | 14 | 8 | 10 |
| (March 1981 prices) | 12 | 6 | 7) |

An economic assessment of the effect of continuing work on Grain is in preparation by the industry.

- (iii) General squeeze on current/capital expenditure

This could be applied by reducing the industry's borrowing requirement by say:

Table B.2.12

| | 1982-83 | 1983-84 | 1984-85 |
|--|---------|---------|---------|
| | 25 | 25 | 25 |

3/4 SCOTTISH ELECTRICITY BOARDS

3. NORTH OF SCOTLAND HYDRO-ELECTRIC BOARD

Table B.3.1

| | £ million estimated outturn prices (Change on Cmnd 8175 in brackets) | | | |
|--|---|---------|---------|---------|
| | 1981-82 | 1982-83 | 1983-84 | 1984-85 |
| <u>Capital Requirements</u> | | | | |
| 1. Fixed assets in UK | 45(+1) | 56(+8) | 52(+3) | 57 |
| 2. Other | 29(-6) | 43(+8) | 40(+4) | 43 |
| TOTAL (1+2) | 74(-5) | 99(+16) | 92(+7) | 100 |
| <u>Financed by</u> | | | | |
| 3. Internal resources | 42(-5) | 48(-10) | 48(-15) | 52 |
| 4. Grants | 14(-) | 8(+2) | 9(-) | 8 |
| 5. Leasing | 1(-) | 1(-) | 1(-) | 1 |
| 6. Short-term borrowing | -23(-2) | -(-) | -(-) | - |
| 7. Long and medium term borrowing | 40(+2) | 42(+24) | 34(+22) | 39 |
| <u>Total external finance</u> | | | | |
| (4+5+6+7) | 32(-) | 51(+26) | 44(+22) | 48 |
| 8. Industries general inflation assumption (%) | 14 | 11 | 10 | 10 |
| (Change on Cmnd 8175 attributable to this) | (-) | (+2) | (+2) | |
| <u>MEMORANDUM</u> | | | | |
| 9. Assumed increase in paybill (%) | 11 | 13 | 11 | 11 |
| 10. Assumed increase tariff (%) | 11 | 11 | 11 | 11 |
| 11. Performance against target | - | - | - | - |

4. SOUTH OF SCOTLAND ELECTRICITY BOARD

Table B.4.1

| | £ million estimated outturn prices (Change on Cmnd 8175 in brackets) | | | |
|--|---|----------|----------|---------|
| | 1981-82 | 1982-83 | 1983-84 | 1984-85 |
| <u>Capital Requirements</u> | | | | |
| 1. Fixed assets in UK | 234(-5) | 421(+50) | 434(+2) | 403 |
| 2. Other | -71(-5) | -61(-23) | -59(+8) | -70 |
| TOTAL (1+2) | 163(-10) | 360(+27) | 375(+10) | 333 |
| <u>Financed by</u> | | | | |
| 3. Internal resources | 86(-10) | 95(-43) | 95(-56) | 91 |
| 4. Grants | - | - | - | - |
| 5. Leasing | - | - | - | - |
| 6. Short-term | - | - | - | - |
| 7. Long and medium term borrowing | 77(-) | 265(+70) | 280(+66) | 242 |
| <u>Total external finance</u> | | | | |
| (4+5+6+7) | 77(-) | 265(+70) | 280(+66) | 242 |
| 8. Industries general inflation assumption (%) | 13.5 | 11 | 10 | 10 |
| (Change on Cmnd 8175 attributable to this) | (-) | (+8) | (+16) | |
| <u>MEMORANDUM</u> | | | | |
| 9. Assumed increase in paybill (%) | 11 | 10 | 10 | 9 |
| 10. Assumed increase tariff (%) | 11 | 11 | 11 | 11 |
| 11. Performance against target | - | - | - | - |

Outlook/Market prospects

1. The Boards are forecasting a small drop in sales in the current year compared with 1980-81 and for the remainder of the review period their sales forecasts envisage average growth of about 1.4 per cent per annum. The assumption underlying the White Paper forecasts was around 2 per cent per annum. No financial target has yet been set for the

Boards (discussions are continuing about pricing policy), but the Boards expect to make a return of around 1 per cent on average net CCA assets in the current year, rising to around 1.5 per cent at the end of the period.

Investment

2. In volume terms some 67.5 per cent of the investment programme of the two Boards taken together over the 4 years to 1984-85 is accounted for by the Torness AGR which is the responsibility of the SSEB. Other generation projects account for about 10.5 per cent and transmission and distribution investment for about 22 per cent. The Torness project is proceeding on schedule and within budget. The increase in the SSEB's expenditure on fixed assets in 1982-83 compared with last year's forecasts is mainly caused by higher spending on Torness, though the size of the increase appears exaggerated because the Board have assumed a higher rate of inflation than allowed for in the revaluation of Cmnd 8175 figures to cash. Apart from this, the Boards' forecasts of expenditure on fixed assets show no increase in real terms over last year's plans - the apparent increases for NSHEB and for SSEB in 1983-84 result from the Boards' higher inflation assumptions. Roughly half the expenditure on generation other than Torness consists of investment in modifications to power stations to extend operating life or improve performance. In general this investment yields real rates of return in excess of 10 per cent. The remainder consists of the final stages of completion of Peterhead Power Station, new investment in diesel generating capacity to meet growing demand on NSHEB's island system and investment in alternative energy sources (wind and hydro) to reduce system operating costs. The planned transmission and distribution investment, which includes a small amount of miscellaneous investment in offices, vehicles etc, is generally required to provide connections for new supplies and to maintain the operation of the system at an acceptable level of safety and reliability.

3. A large part of the planned investment at Torness is already committed and any reduction in this provision would disrupt the project and push up its ultimate costs. Some of the proposed expenditure on modifications to power stations is not essential, but postponement of these projects would increase generating costs and reduce the Boards' profits in the medium term. The same applies to NSHEB's small investment in new run-of-river hydro schemes (£10.5 million (cash) over the period). The new diesel capacity planned by NSHEB is required to meet the current forecast demand, but there may be scope for postponement in due course if growth is less buoyant than expected. The Board's wind energy programme is part of a Department of Energy research project and involves negligible expenditure. The bulk of the Boards' transmission and distribution programme consists of essential work; some distribution expenditure may eventually be postponed if demand does not grow in line with the Boards' forecasts. The Scottish Office believe that a limited amount of investment for which there is a sound economic case has been excluded from the programme because of financing constraints: this includes further projects to

improve the efficiency of power stations and the replacement of elderly distribution equipment.

Financing

4. In 1980-81 the Boards budgeted for break-even in historic cost terms, in the absence of a financial target, but in the event achieved a combined surplus of £27.5 million, on a turnover of £868 million. The Boards' external financing requirements in 1980-81 were £42 million and £32 million for NSHEB and SSEB respectively, compared with the EFLs of £59 million and £73 million, a combined undershoot of £57 million. This resulted mainly from lower than forecast working capital requirements, partly caused by lower fossil fuel prices.

5. The Boards' internal resources forecasts assume a general inflation rate of 12 per cent in the current year and 10 per cent thereafter, with 11 per cent tariff increases each year from April 1982. Coal prices are expected to rise by 10 per cent in November 1981 and by 2 per cent per annum in real terms thereafter, and salaries to rise in line with general inflation. The White Paper forecasts based on last year's review assumed much higher tariff increases (a 10 per cent real increase over the 4 years 1981-85 against 2 per cent in the current forecasts), because the Boards believed at that time that these would be required by Government pricing policy. The current forecasts are closer to the Boards' own view of the path tariffs should follow in the medium term. Combined with lower sales forecasts on last year, the lower tariff increases result in a substantial reduction in the Boards' internal resources. So, although the Boards' total capital requirements remain roughly constant in real terms in 1982-83 and 1983-84 (and fall in 1984-85), their requirement for external finance is significantly increased.

6. NSHEB's financing forecasts assume a continuing annual grant towards the Board's deficit on its supplies to the Invergordon smelter. Since this deficit is financed by borrowing which is repaid on receipt of these grants, the latter have in themselves a neutral effect on public expenditure. The Board's NLF borrowing forecasts assume that the present dispute with the British Aluminium Company (BACo) remains unresolved until the end of the period. If it were resolved sooner, and in the Board's favour, there could be a reduction in the Board's external financing requirement in one of the later years of as much as £50 million.

Financing Constraints

7.(i) Tariffs

The prospect for reductions through higher tariff increases depends on decisions yet to be taken concerning the Boards' financial target or targets and the pricing policy which should underlie this. In turn these decisions will be strongly influenced by Ministers' attitude to future tariff increases in England and Wales; the electricity industry in England and Wales is

reviewing the prospects for achieving its target and Ministers will need to review its future pricing policy in the light of the results of the review. The Scottish Boards consider that tariff increases above the level in their forecasts would further depress sales and exacerbate their problems of excess capacity; they also argue that the further switch from electricity to gas which would follow would be wrong in energy policy terms. However, the table below shows the reduction in the Boards' external financing requirements if tariffs were raised by a further 1 per cent and 5 per cent a year over the IFR period:

Table B.4.2

| | | £ million (outturn prices) | | |
|-------------------------|-------|----------------------------|---------|---------|
| | | 1982-83 | 1983-84 | 1984-85 |
| 1% extra on tariffs p.a | NSHEB | 2 | 5 | 8 |
| | SSEB | 15 | 23 | 31 |
| | Total | 17 | 28 | 39 |
| 5% extra on tariffs p.a | NSHEB | 8 | 19 | 31 |
| | SSEB | 35 | 57 | 93 |
| | Total | 43 | 76 | 124 |

[Notes: 1 per cent on tariffs assumed to cause 0.3 per cent loss of sales; 5 per cent on tariffs assumed to result in nil growth in sales. No account has been taken of any consequential reductions in the Boards' working capital requirements.]

(ii) Capital Investment

Leaving aside Torness only about 5 per cent of the Boards' investment programme (£20 million -£25 million a year) can be regarded as optional in the sense that it is not required to meet demand or to maintain the present system. This remaining 5 per cent appears to be desirable since it consists of projects which will reduce the Boards' operating costs and are expected to yield real rates of return well in excess of 5 per cent. Cuts here would be difficult.

(iii) General squeeze on current and capital expenditure

The main scope for reductions in current expenditure lies in lower coal prices, which are largely beyond the Boards' control. Labour costs account for only 16 per cent or so of total costs. Nevertheless, a general squeeze on both current and capital expenditure might be applied by reducing the Boards' external finance by £5 - 10 million a year.

5. BRITISH GAS CORPORATION

Table B.5.1

| | | £ million estimated outturn prices (Change on Cmnd 8175 in brackets) | | | |
|-------------------------------|---|---|-------------|-------------|---------|
| | | 1981-82 | 1982-83 | 1983-84 | 1984-85 |
| <u>Capital Requirements</u> | | | | | |
| 1. | Fixed assets in UK | 685(-48) | 989(+97) | 1041(+207) | 991 |
| 2. | Other | 154(+18) | 252(+41) | 168(-66) | 242 |
| | TOTAL (1+2) | 839(-30) | 1241(+138) | 1209(+141) | 1233 |
| <u>Financed by</u> | | | | | |
| 3. | Internal resources | 723(-536) | 1049(-914) | 1269(-1060) | 1485 |
| 4. | Grants | - | - | - | - |
| 5. | Leasing | -11(-) | -6(-) | -3(-) | -1 |
| 6. | Short-term borrowing | 166(+126) | 212(+237) | -42(-18) | -140 |
| 7. | Long and medium term borrowing | -39(+380) | -14(+815) | -15(+1219) | -111 |
| <u>Total external finance</u> | | | | | |
| | (4+5+6+7) | +116(+506) | +192(+1052) | -60(+1201) | -252 |
| 8. | Industries general inflation assumption (%) | 14 | 11 | 9 | 9 |
| | (Change on Cmnd 8175 attributable to this) | | -33 | -88 | -92 |
| MEMORANDUM | | | | | |
| 9. | Assumed increase in paybill (%) | 12.7 | 10.3 | 9.8 | 10.5 |
| 10. | Assumed increase 1 April | 15 | 12 | 11 | 11 |
| | tariff (%) 1 October | 10 | 10 | | |
| 11. | Performance against target (CCA return on assets: target 3.5% average 1980-81 to 1982-83 (see para.13 below)) | 1.3 | 2.6 | 2.9 | 3.6 |

1. British Gas's forecast of demand is as follows, with the comparable figures in Cmnd 8175 in brackets:-

Table B.5.2

| billion therms | 1981-82 | 1982-83 | 1983-84 | 1984-85 |
|----------------|------------|------------|-------------|---------|
| Domestic | 8.7(8.7) | 9.0(8.8) | 9.35(9.0) | 9.7 |
| Commercial | 2.2(2.3) | 2.3(2.5) | 2.4 (2.6) | 2.5 |
| Industrial | 6.7(6.6) | 6.9(7.1) | 6.95(7.2) | 6.85 |
| Total | 17.6(17.6) | 18.2(18.4) | 18.7 (18.8) | 19.1 |

2. Domestic sales are up compared with the previous forecasts, but commercial and industrial sales are down due largely to the recession. Despite continuing marketing restrictions on new industrial contracts peak demand is forecast to rise from 98m therms a day in 1980-81 to 108m therms a day in 1983-84. The recession has had little effect on the potential level of demand, and hence the peak problem. The peak supply - demand balance is expected to remain tight until after 1983-84 with a possibility of supply interruptions in each winter up to and including 1983-84.

Investment Plans

3. British Gas require capital investment projects of a revenue earning nature eg pipeline reinforcements investment in compressors etc., to show a positive NPV when discounted at 10 per cent real. For non revenue (eg safety related) investments the least cost solution is used, although for these projects other criteria may be taken into account such as the need to meet statutory obligations.

4. The main components of the investment programme are:

Table B.5.3

(£m outturn prices)

| | 1981-82 | 1982-83 | 1983-84 | 1984-85 |
|--|---------|---------|---------|---------|
| <u>Major Projects</u> | | | | |
| Morecambe Bay | 145 | 320 | 266 | 104 |
| Rough | 90 | 192 | 194 | 54 |
| Pipelines | 87 | 82 | 28 | 0 |
| Gas Gathering Pipeline | 0 | 100 | 0 | 0 |
| Gas Storage | 18 | 14 | 4 | 2 |
| <u>Other (including essential engineering)</u> | | | | |
| | 345 | 281 | 549 | 831 |
| Total | 685 | 989 | 1041 | 991 |

5. All these projects are designed to safeguard the industry's supply/demand position. The efforts of the Corporation to improve security of supply have suffered a serious setback as a result of further delays in the Brent field. Apart from that the major increases in peak supplies over the next five years will come from the Rough and Morecambe fields; for the Rough field the target is now to reach an output of 4m therms/day by the autumn of 1985 and to increase this to 10m therms/day for the winter of 1985-86. This represents a delay of one year compared with the target given in last year's Corporate Plan. The development of the North Lobe of the Morecambe field (Phase 2 of the project) has already been deferred for a year. This means that the target of achieving gas availability during the winter of 1983-84 - essential in view of the tight supply/demand position then expected - is an extremely difficult one to meet with no scope for further delays.

6. The Corporation's forecast of £100 million expenditure on the gas gathering projects in 1982-83 is based on the now defunct Bank of Scotland interim financing proposal.

7. In addition to the major projects there is a substantial amount of expenditure on essential engineering work aimed at maintaining or strengthening the integrity of the gas system. It is the Corporation's assessment that this expenditure is the minimum necessary to meet the supply and demand requirements. There is also some £275 million expenditure over the period in conjunction with BGC's partners for the development of oil and gas fields.

8. Engineering expenditure (about £800 million over the four years of the IFR) is particularly concentrated on the mains replacement programme recommended in the King Report on gas explosions. Expenditure on such items as vehicles, new meters and distribution depots amounts to over £400 million. British Gas say that action has been taken to defer such expenditure in the past but it cannot be continually deferred without lasting detriment to the industry. Financial constraints have already had an adverse effect on the timing of expenditure on Regional marketing; customer service, administration, and general engineering expenditure.

Financing

(i) Internal Resources

9. Although at first sight BGC's internal resources have deteriorated by some £2 billion from 1982-83 to 1983-84 compared with Cmnd 8175, about half of the deterioration is accounted for by the application of the gas levy, which was referred to but not quantified in Cmnd 8175:

Table B.5.4

| | 1982-83 | 1983-84 |
|---|---------|---------|
| Change in internal resources | -914 | -1060 |
| Effect of Levy | -455 | -454 |
| Change in internal resources (excluding levy) | -459 | -606 |

The above figures for the levy take account both of direct levy payments and the indirect effects of the levy on interest receivable by BGC and tax payments. Though the levy figures constitute a technical addition to the Cmnd 8175 baseline, it has always been recognised that the levy would increase public expenditure (though not the PSBR) in this way, and no off-setting savings are being sought in respect of these additions. Beyond 1982-83, the levy is assumed to continue at a rate of 5p per therm, as is provided under the Gas Levy Act unless another rate is specified.

10. The main causes of the real (ie non-levy) deterioration of around £1 billion in BGC's internal resources are the expected drop in revenue from gas sales and the increased cost of gas. The fall in the revenue from gas sales of some £525 million is largely due to the effect of the recession on the industrial market. £115 million of this is due to a reduction in volume and £415 million to a fall in the average price.

11. The Corporation's forecasts assume that the domestic tariff will increase by 10 per cent p.a in real terms in the years 1981-82 and 1982-83 as Ministers agreed when their 3 year financial target was set in January 1980. For 1983-84 and 1984-85 they are forecasting that domestic prices will rise by 2 per cent p.a in real terms, the level they judge necessary to enable them to maintain a satisfactory return from the domestic market and to reflect increases in costs. Industrial contract prices are assumed by BGC to rise broadly in line with oil prices, but with the tempering of price increases for 1981-82 and 1982-83 (costing £78 million and £73 million respectively) announced in the Budget.

12. The cost of gas is forecast to increase substantially over 1982-83 and 1983-84 reflecting the higher proportion of high-cost supplies from the Northern Basin gasfields year by year gas suppliers. BGC now expect gas costs to be even higher (an extra £250 million) than was forecast in Cmnd 8175 mainly because of a further increase in certain prices reflecting additional investment by producers in order to increase peak availability in later years.

13. The average rate of return which BGC forecasts to achieve over the three year period 1980-81 to 1982-83 is 1.8 per cent; the shortfall on the target return of 3 1/2 per cent principally due to the reduction in industrial gas sales because of the economic recession, though there has also been an upward revision of the asset base. For the three year period beyond 1982-83 the industry is forecasting an average rate of return of 3 1/2 per cent.

(ii) External Financing Requirement

14. The EFL for 1980-81 has been achieved. BGC are forecasting that they will meet 1981-82 EFL of - £317 million (pre-levy).

Financing Constraints

15. There are three main options for reducing financing requirements: increasing prices and reducing capital or current expenditure.

(i) Increasing Prices

16. British Gas assume that industrial contract prices will rise broadly in line with prices, although they will continue to maintain the existing relationship: i.e. some 70 per cent of the gas oil price for firm gas contracts, and some 85 per cent of heavy fuel oil price for interruptible gas. BGC consider that in the present economic conditions there is virtually no scope for further increases in industrial prices. A 5 per cent increase in industrial gas prices in 1982-83, reflected in price levels in the later years, would bring about a following improvement in BGC's external financing position:

Table B.5.5

| 1982-83 | 1983-84 | 1984-85 | £ million Outturn prices |
|---------|---------|---------|--------------------------|
| 25 | 78 | 91 | |

17. Domestic tariffs are due to rise by 10 per cent in October 1981 with a further 10 per cent real increase in 1982-83. Current estimates are that domestic prices would then be some 16 per cent below industrial prices, taking account of the higher costs of supplying the domestic market. Each additional 1 per cent increase in domestic tariffs from 1 April 1983, reflected in pricing levels in future years, would improve BGC's external finance position as follows:

Table B.5.6

| 1982-83 | 1983-84 | 1984-85 | £ million Outturn prices |
|---------|---------|---------|--------------------------|
| 22 | 20 | 21 | |

A similar additional increase starting on 1 April 1983-84 would yield:

| | | |
|---|----|----|
| - | 22 | 22 |
|---|----|----|

The figures in Cmnd 8175 for 1983-84 included as a planning assumption (not a pricing decision by Ministers) an additional 10 per cent real increase in 1983-84, reflecting the expectation that domestic gas would still be well below economic price levels at the end of 1982-83. Compared with BGC's IFR forecasts, which are based on a 2 per cent rise, it follows from the above that such an additional increase would bring in £176 million in 1983-84 and £176 million in 1984-85.

(ii) Capital Expenditure

18. British Gas say that further deferment of either new capital expenditure or replacement expenditure would have an adverse effect on the industry's longer term developments and operational safety levels.

19. The two major capital projects, Morecambe and Rough, are being considered in detail in the context of oilfield development approvals and their economic viability and the need for their full development are being examined. But it seems probable that any decision to cut or delay either of these projects would increase the risk of a supply shortfall in the winter of 1983-84.

(iii) Current Costs

20. The Department has made efforts to ensure that everything possible is being done to improve BGC's efficiency and a performance aim to reduce unit costs (excluding the cost of gas purchase, which is outside BGC's direct control) by 5 per cent in real terms over the period of the present financial target has been agreed with the Corporation and announced. Unit costs are thus expected to increase at a lower rate than inflation. Wage costs are assumed to be in line with the national average after 1981-82 and trading costs are assumed to increase in line with the WPI.

6. BRITISH NATIONAL OIL CORPORATION

Table B.6.1

| | £ million estimated outturn prices (Change on Cmnd 8175 in brackets) | | | |
|--|---|----------------|---------------|---------------|
| | 1981-82 | 1982-83 | 1983-84 | 1984-85 |
| <u>Capital Requirements</u> | | | | |
| 1. Fixed assets in UK | 363.1(-6.9) | 453.7(+68.4) | 503.2(+109.8) | 669.8(+256.7) |
| 2. Other | 5.6(-13.4) | -12.8(-18.1) | 6.5(-18.7) | 6.8(-19.6) |
| TOTAL (1+2) | 368.7(-20.3) | 440.9(+50.3) | 509.7(+91.1) | 676.6(+237.1) |
| <u>Financed by</u> | | | | |
| 3. Internal resources | 589.5(-19.9) | 501.1(-150.4) | 571.6(-191.8) | 620.0(-181.6) |
| 4. Grants | - | - | - | - |
| 5. Leasing | -0.4(+0.4) | -0.4(+0.2) | -0.5(-0.1) | -(+0.5) |
| 6. Short-term borrowing | - | - | - | - |
| 7. Long and medium term borrowing | -220.4(-0.8) | -59.8(+200.5) | -61.4(+283) | 56.6(+418.2) |
| <u>Total external finance</u> | | | | |
| (4+5+6+7) | -220.8(-0.4) | -60.2 (+200.7) | -61.9(+282.9) | 56.6(+418.7) |
| 8. Industries general inflation assumption (%) | 15 | 12.7 | 11.7 | 10.9 |
| (Change on Cmnd 8175 attributable to this) | -8.3 | -24.3 | -52.6 | -78.5 |
| MEMORANDUM | | | | |
| 9. Assumed increase in paybill (%) | 14 | 11 | 10 | 9 |
| 10. Assumed increase tariff (%) | 10 | 10 | 10 | 10 |
| 11. Performance against target | | No target set | | |

Outlook/market prospects

1. The Petroleum and Continental Shelf Bill (PCSB), published in February, provides for the introduction of private capital into BNO's upstream operations and modifications to the Corporation's financial structure, including the abolition of the National Oil Account (NOA). Due to pressure on the Parliamentary timetable, it has not been possible to proceed further with the Bill this session. It is, however, intended to reintroduce the Bill as a matter of priority next session. The IFR forecasts are based on continued public sector ownership of BNO throughout the review period.

2. BNOG achieved a net profit on its oil trading operations of £43.8 million in 1980, compared with £21.5 million in 1979. No financial target had been set for 1980. Now that decisions have been taken about the Corporation's future financial structure, consideration is being given to the establishment of a medium term financial target later this year.

Investment Plans

3. The table below summarises BNOG's capital investment programme. The estimates for existing projects include continued expenditure on five oil fields already in production besides major expenditure on three fields now under development. All these projects take place in partnership with private sector companies and are expected to give rise to real post-tax rates of return of between 15-30 per cent BNOG's cost estimates are generally in line with the Department's expectations. The only Proposed project is the Clyde field, whose development was delayed for two years by the Government last December, on depletion policy grounds. The Administration estimate provides for continued expenditure on the installation of computers, and for the rationalisation of BNOG's office accommodation in Glasgow and Aberdeen.

4. The expenditure provisions for exploration activity are substantially higher than last year's estimates and reflect the current higher level of UKCS drilling activity and the sharp rise in drilling rig costs. They also provide for some exploration expenditure overseas, predominantly in the last two years. The category of Future investments is primarily intended to cover expenditure on a number of potential projects which are expected to come forward in the review period. The bulk of this will be spent on joint venture projects arising under existing licence interests, where the rates of return will be comparable with those for existing projects. The estimates below take into account reductions of £60 million in each of the last two years to reflect the Department of Energy's view that such projects will not be developed as quickly as BNOG believe. This category also includes some provision for expenditure on farm-ins and acquisitions.

Table B.6.2

BNOG Expenditure on Fixed Assets

| £m outturn | 1981/82 | 1982/83 | 1983/84 | 1984/85 |
|--------------------|---------|---------|---------|---------|
| Existing projects | 238.0 | 180.7 | 92.7 | 59.8 |
| Proposed projects | 5.5 | 36.7 | 54.4 | 75.9 |
| Exploration | 86.4 | 147.9 | 177.4 | 220.9 |
| Administration | 9.8 | 13.4 | 28.7 | 13.2 |
| Future investments | 60.0 | 75.0 | 150.0 | 300.0 |
| Total | 363.1* | 453.7 | 503.2 | 669.8 |

*Total for 1981/82 includes slippage factor of -£36.6 million.

Financing

5. BNOG's expenditure is now financed entirely by internally generated resources and the Corporation is reducing its outstanding drawings from the NOA and its obligations under the Britoil financing agreement. This position is expected to continue at least until 1984/85. In 1980/81, BNOG exceeded its forecast cash surplus (£200 million) by £17 million due to underspending on its capital budget, the oil price rises of 1980, and despite the rise in the exchange rate.

6. The Corporation's revenue forecasts depend almost entirely on two factors; oil production, for which its forecasts are generally in line with the Department's; and the sterling oil price, where BNOG assume a price of £17.50/bbl in 1981 (eg \$37/bbl at \$2.10 exchange rate) rising by 10 per cent pa. In the present circumstances of the oil market it is difficult to comment on BNOG's assumptions.

7. By comparison with the Cmnd 8175 figures, BNOG's estimates of the cash surplus to be generated over the review period have deteriorated by £1,000 million, though 70 per cent of this arises in the last two years.

Table B.6.3

Change in BNOC cash surplus forecasts against Cmnd 8175

| (£m outturn) | 1981/82 | 1982/83 | 1983/84 | 1984/85 |
|----------------------------------|---------|---------|---------|---------|
| due to: change in revenue | -139.2 | -200.7 | -282.9 | -418.9 |
| increase in capital requirements | -159.5 | -150.4 | -191.8 | -181.9 |
| | 20.3 | -50.3 | -91.1 | -237.0 |

The net change for 1981/82 is due solely to the inclusion of a provision for Supplementary Petroleum Duty, announced in the recent Budget. Over the review period as a whole, two-thirds of the decline is attributable to lower revenue forecasts, where the main factor has been a substantial reduction of BNOC's oil production forecasts. The increase in capital expenditure is due mainly to the increases in exploration expenditure (see para 4).

Financing Constraints

8. BNOC operates in an international market, where the price is dictated by factors outside the Corporation's control, so that the scope for BNOC to influence its revenues is minimal. Furthermore it is the Government's policy that North Sea oil should be sold at its full market price. BNOC also has little control over the production levels at its North Sea fields, since operational decisions are taken within the joint ventures.

9. The Corporation's ability to find savings on its capital investment programme is limited. Within any one year, 80-90 per cent of its budget would be committed through joint ventures in which it has neither a controlling vote nor a veto, and savings in this area could only be achieved by selling licence interests - a process which could take considerable time if the best price was to be achieved. The other major part of BNOC's programme is the provision for Future investments, which includes both unspecified future developments on existing licence interests, and acquisitions or farm-ins. In the former case BNOC is unlikely to be the dominant voice in determining the rate of development, and the arguments above limiting their ability to reduce expenditure will largely apply. Expenditure on acquisitions and farm-ins, on the other hand, does lie within BNOC's control, and is proposed at a level intended to avoid contraction of the Corporation in the future. The expected division of Future investments expenditure between the two categories is broadly:

Table B.6.4

| (£ million) | 1982-83 | 1983-84 | 1984-85 |
|-------------------|---------|---------|---------|
| Existing licences | 45 | 100 | 210 |
| Acquisitions etc | 30 | 50 | 90 |
| Total | 75 | 150 | 300 |

10. If the Corporation were to adopt a ten per cent "slippage" factor for the years from 1982-83 as they have for 1981-82, their capital expenditure forecasts would be reduced by:

| (£ million) | 1982-83 | 1983-84 | 1984-85 |
|-------------|---------|---------|---------|
| | 45 | 50 | 65 |

On past experience BNOC's partners' capital expenditure forecasts may escalate further. It is therefore difficult to assess what slippage may be justified beyond the current year.

7. BRITISH STEEL CORPORATION

Table B.7.1

TOTAL EXTERNAL FINANCE

| | 1982-83 | £m outturn prices | |
|---------------------------|---------|-------------------|---------|
| | | 1983-84 | 1984-85 |
| British Steel Corporation | 350* | 350* | 350* |

*The figures in all years are highly provisional estimates put in by the Government, without consulting the Corporation, pending Ministerial decisions on BSC's medium-term plan which is due in the autumn. That for 1982-83 is a Treasury estimate of the lowest figure BSC can manage with; DOI would put it at £375 million. The figures for 1983-84 and 1984-85 are a DOI view of the trend of future requirements; however the Treasury would look for a sharply declining profile in cash terms.

| | | | | |
|--|-----------|-----------|-----------|-----|
| 1. Long and medium term borrowing | 500(-200) | 400(-200) | 400(-200) | 400 |
| Total external finance | 500(-200) | 400(-200) | 400(-200) | 400 |
| 2. Industries general inflation assumption | 11 | 11 | 11 | 11 |
| Change on Cash 1975 attributable to this | +120 | +110 | -120 | |

MEMORANDUM

| | | | | |
|------------------------------------|------------------|------|------|------|
| 3. Assumed increase in payroll (%) | 12.0% | 10% | 10% | 11% |
| 4. Assumed increase (%) (%) | 1.7% | 1.7% | 1.7% | 1.7% |
| 5. Performance against target* | -4.7% against 5% | 1.0 | 1.0 | 1.0 |

Notes: * See paragraph 10 of text below

Output/Market prospects

1. Despite a reduction in BT's demand forecasts to reflect lower growth in the economy, steel requirements remain a growth industry. Total requirements increased by 1 per cent during the recession year of 1981/82 and are forecast to grow at an average of about 4 per

8. BRITISH TELECOM

Table B.8.1

| | £ million estimated outturn prices (Change on Cmnd 8175 in brackets) | | | |
|--|---|------------|------------|---------|
| | 1981-82 | 1982-83 | 1983-84 | 1984-85 |
| <u>Capital Requirements</u> | | | | |
| 1. Fixed assets in UK | 1927(-221) | 2537(+500) | 2977(+781) | 3261 |
| 2. Other | 311(+273) | 150(-308) | 71(-392) | 139 |
| TOTAL (1+2) | 2238(+52) | 2687(+192) | 3048(+389) | 3400 |
| <u>Financed by</u> | | | | |
| 3. Internal resources | 1738(-268) | 2171(-293) | 2505(-189) | 2891 |
| 4. Grants | - | - | - | - |
| 5. Leasing | 58(+25) | 53(+4) | 55(+6) | 51 |
| 6. Short-term borrowing | 107(-107) | 3(-3) | - | - |
| 7. Long and medium term borrowing | 549(+402) | 466(+484) | 488(+571) | 458 |
| <u>Total external finance</u> (4+5+6+7) | 500(+320) | 516(+485) | 543(+577) | 509 |
| 8. Industries general inflation assumption (%) | 11 | 11 | 10 | 10 |
| (Change on Cmnd 8175 attributable to this) | +£2m | +£1m | -£2m | |

MEMORANDUM

| | | | | |
|------------------------------------|-----------------|------|------|------|
| 9. Assumed increase in paybill (%) | 15.4% | 14% | 13% | 11% |
| 10. Assumed increase tariff (%) | 8.7% | 7.2% | 6.5% | 5.9% |
| 11. Performance against target* | 4.7% against 5% | 5.0 | 5.0 | 5.0 |

Notes * See paragraph 10 of text below

Outlook/Market prospects

1. Despite a reduction in BT's demand forecasts to reflect lower growth in the economy, telecommunications remains a growth industry. Total connections increased by 5 per cent during the recession year of 1980/81 and are forecast to grow at an average of about 4 per

cent a year over the following four years, with residential penetration rising from 74 per cent in 1980/81 to 86 per cent in 1985/86. Rapid growth is forecast to continue, at around 15 per cent a year, in modems (connecting devices used in the transmission of data), and there is also rapid growth (around 20 per cent a year) in international telephone calls.

2. The British Telecommunications Bill, which is to establish British Telecom as a separate nationalised industry and provide powers for the liberalisation of the telecommunications market, is expected to become law in July. The supply of attachments to the telecommunications network (other than the prime telephone instrument) is to be liberalised in phases over the three year period 1981-83. The Government is giving sympathetic consideration to the recommendation of the Beesley report in favour of the freedom to offer services to third parties over BT's network, and is also considering the possibility of allowing the provision of an alternative network. BT's 1981 medium term plan allows for the planned liberalisation of the supply of attachments, and for some liberalisation of network use (but falling short of the full Beesley recommendation). The implications of liberalisation for BT's financial prospects will require further assessment in the light of the decisions the Government takes.

Investment plans

Table B.8.2

British Telecom's medium-term plan 1981: Expenditure on fixed assets

| | £ million outturn prices (Change on Cmnd 8175 in brackets) | | |
|--------------------------------------|---|------------|---------|
| | 1982-83 | 1983-84 | 1984-85 |
| Accommodation | 339(+54) | 362(+49) | 296 |
| Exchange equipment | 924(+268) | 1117(+381) | 1280 |
| Local lines | 221(+49) | 204(+49) | 196 |
| Subscriber circuits | 467(-1) | 543(+43) | 616 |
| Trunks | 148(+73) | 232(+154) | 280 |
| Junctions | 116(+29) | 142(+57) | 167 |
| Non-voice terminals | 75 | 83 | 98 |
| Non-voice network |) (+3) |) (+7) | 48 |
| Miscellaneous | 36 | 46 | 27 |
| Motor transport | 19(+9) | 23(+11) | 36 |
| International (including satellites) | 38(-) | 32(-1) | 126 |
| Computers | 111(+53) | 110(+33) | 91 |
| | 73(-4) | 83(-2) | |
| TOTAL | 2567(+530) | 2977(+781) | 3261 |

Note: The changes on Cmnd 8175 figures shown in brackets are approximate only.

3. The Corporation is planning substantial increases in investment as shown in the above table. A main aim of the programme is the modernisation of the network through the replacement of outdated electromechanical exchanges by electronic and digital switching equipment, and the digitalisation of the transmission network. The new equipment will bring (amongst other service benefits) the major improvements in the quality and speed of transmission which are needed for 'information technology' applications such as funds transfer and high speed data transmission between computers. It is also cheaper to maintain than the old. BT is aiming to have digitalised transmission and switching between 30 major centres by 1986, and to complete digitalisation of trunk switching and transmission by 1992.
4. A second main aim of the programme is to meet the growth in demand described in paragraph 1. If demand is not met, the result would be delays in the provision of service, such as occurred in 1980-81, which can have serious consequences for business and domestic users.
5. A third, smaller element in BT's programme lies in steps to improve service quality, for example by the replacement of coin operated telephones with more modern designs, and the provision of more reliable electronic meters for assessing customers' bills.
6. About one third of the total investment projected over the period of BT's current medium term plan (1981-82 - 1985-86) represents investment in growth of the main monopoly inland network including the prime instrument; about a further 30 per cent represents expenditure on its modernisation, and 5 per cent represents other quality improvements. Investment in the growth and modernisation of the highly profitable international services accounts for a further 5 per cent of the total; investment in the specialised telex and packet switching services 2 per cent of the total; investment in the competitive subscriber apparatus area about 10 per cent of the total; and the balance of about 15 per cent comes from miscellaneous back-up requirements, chiefly accommodation (for exchanges and people), vehicles and computers.
7. The major part of the increase in total investment in the above table is due to an increased volume of investment on modernisation (the increases mainly relate to transmission), and to increased costs of the modernisation programme stemming from revised estimates of the start-up costs of introducing new technology and revised estimates of the timing of payments on system X contracts. A further increase in costs stems from past cost increases and projected future increases in particular on wages (which form a significant cost element in local lines and subscriber circuits). Compared with 1980 plans, there are increases and decreases in the volume of investment other than that connected with modernisation of the network; the net effect is a volume increase of some £60m in

1982-83, followed by an effect of about zero in 1983-84 and a decrease in this type of investment in 1984-85.

8. BT's investment programme as a whole is validated against the requirement of a 5 per cent rate of return. Investment in growth pays for itself quite quickly, through connection charges and rentals during the initial phase of equipment life. Although BT's growth forecasts will no doubt require amendment in the light of experience, there is nothing in the past history or their forecasting on their current economic projections to suggest that the growth in demand is being over-estimated. Investment in modernisation shows a positive net present value against a TDR of 8 per cent, on the basis of a conservative assessment based mainly on cost savings (ie excluding benefits from enhanced facilities and improved quality). The economic case for the modernisation programme therefore looks a robust one; this judgement might have to be re-assessed if there were a further major escalation of costs, though the scope for this looks more limited now that BT's full digitalisation programme has been worked out in detail for the first time.

Financing

9. British Telecom made a financial return on net assets of 4.6 per cent in 1980-81, compared with the 6 per cent return planned when its EFL was set. BT planned to recoup higher than expected cost increases from its tariff increase in November 1980. These cost increases included those arising from the 1980 pay settlement arbitration awards and higher than expected general inflation. But it was subsequently prevented from making the 6 per cent return by lower than expected sales volume and higher depreciation charges. The outcome represents a short-fall of 0.4 per cent below the target of 5 per cent which is still formally in force.

10. BT plans are based on a 5 per cent real return in the three years 1982-83 - 1984-85 rather than the 6½ per cent return which formed the basis of Cmnd 8175 figures. The reduction is due principally to the rate of growth in demand being below that previously forecast; and to the need to prevent excessive increases in prices to residential customers at a time when tariffs need to be rebalanced in order to reflect costs more closely. The need to rebalance tariffs may be reinforced by Government's policies of introducing competition. BT is assuming tariff increases of rather below the RPI, with the intention if possible of containing the rise in the residential bill to about the increase in the RPI. Its wage costs are assumed to go up in line with average earnings in the economy, and real unit costs are projected to improve at around 4.3 per cent per annum from 1982-83 onwards - better than the long-run historical trend - following the disappointing performance of 1980-81 and the current year. Over the five year period of their current plan, BT projects a 45 per cent increase in output for a 2 per cent increase in staff.

11. The increase in investment expenditure described in paragraph 7, taken together with BT's inability to earn the 6½ per cent return previously projected, imply a major increase in their projected external financing requirement compared with the PES provision. BT's depreciation projections have increased sharply compared with their 1980 plans (for reasons which are still under discussion with the industry) and this broadly cancels out the effects on internal resources of the lower projected rate of return. As a result, internal resources are projected as much the same as in the 1980 plan, and the increase in BT's external financing requirement over the three years 1982-83 - 1984-85 is of much the same size as the increase in their investment requirements. Comparison with the base-line in Cmnd 8175, does not however give an accurate picture of the effects of the increased depreciation, since the underlying projections for internal resources and depreciation in Cmnd 8175 were based on earlier and provisional BT estimates. The Cmnd 8175 baseline also contains higher estimates of working capital requirements than in either BT's 1980 or their 1981 Medium-Term plans.

Financing Constraints

Table B.8.3

| | £ million (outturn prices) | | |
|----------------------------------|----------------------------|---------|---------|
| <u>Capital requirements</u> | 1982-83 | 1983-84 | 1984-85 |
| Cmnd 8175 | 2495 | 2659 | [2792] |
| BT medium-term plan | 2717 | 3048 | 3400 |
| Department's recommended figures | 2687 | 3048 | 3400 |
| <u>Internal resources</u> | 1982-83 | 1983-84 | 1984-85 |
| Cmnd 8175 | 2464 | 2694 | [2829] |
| BT medium-term plan | 2131 | 2405 | 2741 |
| Department's recommended figures | 2171 | 2505 | 2891 |
| <u>External Finance</u> | 1982-83 | 1983-84 | 1984-85 |
| Cmnd 8175 | 31 | -34 | [-36] |
| BT medium-term plan | 586 | 643 | 659 |
| Department's recommended figures | 516 | 543 | 509 |

12. DOI and Treasury officials have considered whether BT's financing requirements can be reduced by action on their costs, tariffs, or investment requirements.

13. Consultant management accountants are at present investigating the scope for further reductions in BT's cost levels, and benefits are expected to flow in the medium term from the introduction of better financial management. However the targets in BT's 1981 MTP for improvements in efficiency are stretching ones compared with historical performance, and DOI officials feel that it would be over-optimistic to assume more than this at present while the question of cost levels is under investigation. Treasury officials broadly endorse this view.

14. Extra price rises would be technically possible, but resistance to major increases must be expected following the very large increases necessary in 1980. Such increases would focus inter alia on the sensitive domestic rental charges which need to go up more than average.

15. Officials consider investment in modernisation to be justified both for its economic return and for its role in promoting the use of information technologies. A thorough appraisal of the effects of a £200m cut in modernisation investment in 1981-82 concluded that the rate of return sacrificed at the margin would be at least 16 per cent in real terms. There is no reason to think the picture is significantly different for cuts in (say) 1982-83. A reduction of investment in growth may be technically possible, but would require a political decision as to whether extra price increases to choke off demand are acceptable. (The price elasticity of BT's services is generally low.) The one agreed investment saving is therefore a £30m reduction in expenditure on accommodation in 1982-83 due to the deferral of the start of an office project.

16. A more promising possibility, at least in the next two years, lies in financing savings from the Government's policies of promoting competition and privatisation in the telecommunications service. Under this head, BT is already planning savings from increased provision of customer apparatus by private finance with savings of £70m in 1982-83; £85m in 1983-84; and £110m in 1984-85. DOI and Treasury officials estimate that a further £40m might be realised in 1982-83 from the sale of existing assets and that Ministers should set BT a target of further savings of £100m in 1983-84 and £150m in 1984-85 from the proceeds of disposals, the financing of investment through joint ventures not controlled by BT and reduced market share due to liberalisation.

9. POST OFFICE (POSTAL BUSINESS)

Table B.9.1

| | £ million estimated outturn prices (Change on Cmnd 8175 in brackets) | | | |
|---|---|--------------|--------------|---------|
| | 1981-82 | 1982-83 | 1983-84 | 1984-85 |
| <u>Capital Requirements</u> | | | | |
| 1. Fixed assets in UK | 134.5(-) | 170.2(+63.4) | 156.3(+43.1) | 164.2 |
| 2. Other | -5.5(-0.5) | -16.9() | -14.9() | -15.7 |
| TOTAL (1+2) | 129.0(-0.5) | 153.3(+63.4) | 141.4(+42.7) | 148.5 |
| <u>Financed by</u> | | | | |
| 3. Internal resources | 118.5(-0.5) | 126.1(+21.6) | 149.3(+35.8) | 161.1 |
| 4. Grants | - | - | - | - |
| 5. Leasing | 12.4) | 2.9) | 4.5) | 6.1) |
| 6. Short-term borrowing | 14.8(-) | 36.0(+41.8) | -8.0(+6.8) | -16.5) |
| 7. Long and medium term borrowing | -16.7) | -11.7) | -4.4) | -2.2) |
| <u>Total external finance</u> | | | | |
| (4+5+6+7) | 10.5(-) | 27.2(+41.8) | -7.9(+6.8) | -12.6 |
| 8. Industries general inflation assumption (%) | 11.0 | 12.1 | 10.0 | 10.0 |
| (Change on Cmnd 8175 attributable to this) | 0 | -0.1 | -1.0 | |
| MEMORANDUM | | | | |
| 9. Assumed increase in paybill (%) | 12 | 14 | 11 | 11.5 |
| 10. Assumed increase tariff (%) | 12.1 | 12.1 | 10.1 | 10.7 |
| 11. Performance against target | 2 | 2 | 2 | 2 |
| (2% return on turnover, post interest, from 1978-79 to 1982-83) | | | | |

Outlook and Market Prospects

The British Telecommunications Bill, which will give effect to the main recommendation in the Post Office Review Committee's Report (Cmnd 6850) to separate the

telecommunications business from the rest of the Post Office, is expected to become law in July 1981.

2. The Secretary of State for Industry announced on 16 July 1980 that he intended to make some minor relaxations in the Post Office's letter monopoly, and to take powers to make further relaxations should the performance of the Post Office, for reasons within its control, not be satisfactory. Provisions for the necessary powers to implement these decisions are in the British Telecommunications Bill.

3. On 1 April 1980 the Monopolies and Mergers Commission reported on the Inner London Letter Post and the Post Office has now responded to the recommendations in the report. The most important of the recommendations is that productivity in the London area be brought up to 1968 levels in three years, which would entail an increase of 25 per cent. The Post Office has agreed to set a target of an improvement of 15 per cent over three years, and to seek further improvements thereafter.

4. The postal business now expects its total business volume to remain roughly constant to 1984-85, although whether it does so will depend on whether it can generate sufficient productivity improvement to enable it to hold real prices steady, and on the general climate in the economy. Forecasts for total mail traffic at 10 thousand million items in 1984-85 are slightly down on the 10.1 thousand million forecast last year, mainly due to a fall in letter forecasts.

Investment Plans

5. The Postal business is seeking substantial extra funds for investment in each of the years covered by the Review. The following table breaks these sums down into the main components:

Table B.9.2

Post Office medium-term plan, 1981: Investment in fixed assets
(Cmd 8175 figures in brackets)

| | 1982-83 | outturn prices (£m) | |
|----------------------------|--------------|---------------------|---------|
| | | 1983-84 | 1984-85 |
| Postal plant | 35.8(14.1) | 24.9(14.9) | 21.1 |
| Accommodation services | 138.8(56.2) | 122.1(56.7) | 97.0 |
| Motor transport | 43.7(28.1) | 48.6(30.8) | 48.4 |
| Office machines/computers | 13.5(8.4) | 17.4(11.2) | 33.6 |
| Total capital requirements | 231.9(106.8) | 213.1(113.6) | 200.2 |

The largest increase in any individual category is expenditure on accommodation, but investment in each of the other categories is planned to rise substantially in proportionate terms. Three major priorities lie behind these investment figures (although these priorities cannot be related directly to the categories in the above table):

(i) Letter mechanisation

Last year's medium-term plan took into account the needs of the mechanisation programme as a whole, but the MMC report since then has confirmed the need for rapid progress. The Post Office's reappraisal of its existing building stock has suggested a need for substantial expenditure on accommodation on this account in particular - although even with this expenditure the letter mechanisation programme is not now expected to be completed until 1983-84 or 1984-85.

(ii) Derogations from monopoly

The Secretary of State's announcement about derogations from monopoly has led to an increased assessment by the Post Office of the need for investment in the competitive area, particularly in relation to premium services.

(iii) Reassessment of the existing capital stock

Following the handover from the PSA to the Post Office of full responsibility for building maintenance and construction, the Post Office has revised its judgement of the expenditure required to bring the building stock up to standard, many buildings being in need of urgent structural repair. The Post Office has similarly reassessed its need for expenditure on motor vehicles so as to reduce maintenance expenditure and improve reliability of service.

6. Because much of this expenditure is of a replacement nature, designed simply to maintain and improve services, the Post Office has not felt able to subject it to conventional methods of investment appraisal. Discounted Cash Flow techniques have however been applied to the letter mechanisation programme and this is projected to yield a return of well over 8 per cent in real terms. But the difficulty of applying the usual techniques to the programme as a whole makes it hard to assess the strict economic case for the expenditure the Post Office are planning, just as it is difficult to make any judgement of the extent to which past economic investment may have been held back by then current constraints. The fact that Posts' investment programme is mostly devoted to replacement of existing assets means also that it is reasonably robust, and is unlikely to be greatly affected by changes in external circumstances. The extra funds sought for investment in new technology (mainly Optical Character Recognition and packet sorting machinery) are very small (roughly £12 million over the three years taken together).

Financing

7. The forecasts have assumed that the business will meet its financial target of a 2 per cent return on turnover, after interest, throughout the survey period, although the target currently only applies until 1982-83. The target is equivalent to an average return of 4.3 per cent (after depreciation and before interest) on net assets at replacement cost. The industry's performance aim of a zero increase in real unit costs over the period 1977-81 to 1982-83 is not being met but is currently under review.

8. The industry's projections of internal resources are based on a roughly constant business volume, as noted above, and on letter tariff increases at or a little above the rate of inflation. The Corporation have stressed that they do not consider it possible to keep letter tariff increases below the rate of inflation and meet the financial target which has been set. The rate of inflation assumed by the Post Office is 11 per cent in 1981-82, 12 per cent in 1982-83 and 10 per cent thereafter. These figures are significantly above the Government's own assumptions, but lower rates of inflation would affect the business's ability to increase letter tariffs as well as the business's costs, and so would not necessarily improve internal resources as a whole. On the basis of these assumptions, and taking into account roughly £5 million of disposals of assets in each of the three years, the Post Office project improvements in internal resources over and above the levels in Cmnd 8175 of £26 million, £43 million and £52 million in each of the years 1982-83, 1983-84 and 1984-85 respectively.

9. These improvements in internal resources help to go at least some way to offset the industry's increased capital requirements, but the industry's plans still envisage substantial increases in external finance in each of the years - of £110 million in 1982-83, £92 million in 1983-84 and £38 million in 1984-85. In each case, small net repayments in Cmnd 8175 are turned into positive external financing requirements which it is assumed would have to be met in large measure, if not entirely, by medium- and long-term borrowing from the NLF.

Financing Constraints

Table B.9.3

| | £m Outturn Prices | | |
|----------------------------------|-----------------------------|---------|---------|
| | <u>Capital Requirements</u> | | |
| | 1982-83 | 1983-84 | 1984-85 |
| Cmnd 8175 | 89.9 | 98.7 | [103.6] |
| Industry's MTP | 226.7 | 233.2 | 194.0 |
| Department's recommended Figures | 153.3 | 141.4 | 148.5 |

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| | <u>Internal Resources*</u> | | |
|----------------------------------|----------------------------|---------|---------|
| | 1982-83 | 1983-84 | 1984-85 |
| Cmnd 8175 | 104.5 | 113.5 | [119.1] |
| Industry's MTP | *131.1 | 156.3 | 171.1 |
| Department's recommended Figures | *126.1 | 149.3 | 161.1 |

| | <u>External Finance</u> | | |
|----------------------------------|-------------------------|---------|---------|
| | 1982-83 | 1983-84 | 1984-85 |
| Cmnd 8175 | -14.6 | -14.7 | [-15.4] |
| Industry's MTP | 95.6 | 76.9 | 22.9 |
| Department's recommended Figures | 27.2 | -7.9 | -12.6 |

*Internal resources figures have been adjusted to take account of

- (i) Improvement resulting from elimination of industry's earlier forecast tax liability and extra disposals of assets in each year
- (ii) in line 3 some worsening of position (£5 million in 1982-83, £7 million in 1983-84 and £10 million in 1984-85) as a result of lower investment than planned by the Post Office.

10. Department of Industry and Treasury officials, having examined Posts planned additional investment, and given the scale of the nationalised industries' overall financing problem, are agreed that the case for accepting the additional bids in full is unconvincing. As there is little scope for an improvement in internal resources over and above that already projected by the industry, cuts will inevitably have to come from the investment programme.

11. DOI's recommended investment figures are shown in the third line of the table at the beginning of this section. The Department envisages reducing the industry's capital requirements by £73 million in 1982-83, £92 million in 1983-84 and £46 million in 1984-85. The remaining increases would allow for a substantial amount of their investment in accommodation (in particular in respect of mechanisation but also in the competitive area and to relieve cases where buildings are simply inadequate and/or unfit); the capitalisation of leases planned last year but not incorporated into the Cmnd 8175 figures; some upgrading of the motor vehicle fleet (both in connection with the main postal business and the expansion of premium services); extra expenditure on postal plant (particularly in respect of Optical Character Recognition and packet mechanisation); and some investment in computers needed to develop the competitive area. Because of the reduction in Posts' investment programme, DOI and Treasury officials consider it appropriate to make a small reduction in Posts' internal resources in each of the years.

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10. NATIONAL GIROBANK AND REMITTANCE SERVICES

Table B.10.1

£ million estimated outturn prices
(Change on Cmnd 8175 in brackets)

| | 1981-82 | 1982-83 | 1983-84 | 1984-85 |
|--|-----------|-----------------|------------|---------|
| <u>Capital Requirements</u> | | | | |
| 1. Fixed assets in UK | 11.8(0.2) | 9.5(0.8) | 6.1(1.0) | 6.1 |
| 2. Other | 10.0(9.5) | 3.2(-3.0) | 1.1(-6.6) | 3.1 |
| TOTAL (1+2) | 21.8(9.7) | 12.7(-2.2) | 7.2(-5.6) | 9.2 |
| <u>Financed by</u> | | | | |
| 3. Internal resources | 9.6(2.5) | 8.3(-3.2) | 7.5(-4.8) | 10.5 |
| 4. Grants | - | - | - | - |
| 5. Leasing | 4.7(-0.3) | 4.4(1.0) | -0.3(-0.8) | -1.3 |
| 6. Short-term borrowing | - | - | - | - |
| 7. Long and medium term borrowing | 7.5 | - | - | - |
| <u>Total external finance</u> | | | | |
| (4+5+6+7) | 12.2(7.2) | 4.4(1.0) | -0.3(-0.8) | -1.3 |
| 8. Industries general inflation assumption (%) | 11 | 12 | 10 | 10 |
| (Change on Cmnd 8175 attributable to this) | - | +0.3 | - | - |
| MEMORANDUM | | | | |
| 9. Assumed increase in paybill (%) | 12 | 14 | 11 | 11.5 |
| 10. Assumed increase tariff (%) | 11 | 12 | 10 | 10 |
| 11. Performance against target | see text | (no target set) | | |

Prospects

1. Girobank is likely to exceed its financial target of £6.1 million profit before interest on long term loans in 1980-81 by some £0.7 million. It was set a financial target for the years 1979-80 to 1981-82 of earning an average annual return of 13 per cent before payment of NLF interest on its historic mean net assets as well as earning an additional £5.0 million

over the three year period. Girobank expect to meet their target in the current year. The changes in the financing table compared to Cmnd 8175 need to be seen in the context of the levy on banks' non interest bearing deposits which will render Girobank liable to pay £7.5 million in 1981-82. Ministers have agreed that in 1981-82 a compensating injection of capital shall be made, in the form of two thirds PDC and one third NLF, and in addition Girobank shall not be required to pay the dividend on PDC in respect of 1980-81 and 1981-82, which would normally have been expected to amount to £1.7 million in each year.

2. Girobank continued to make good progress in 1980-81 in the growth of personal accounts, which it is estimated will have increased from 853,000 at end 1979-80 to over 950,000 at end 1980-81, although growth in the profitable corporate account sector remains slow.

Investment programme

3. Girobank's investment programme is in aggregate very little changed compared to that in the White Paper - the change in total capital requirements over the period largely results from change in other working capital requirements.

4. The bulk of Girobank's capital expenditure in on computers and ancillary equipment, and in 1981-82 and 1982-83 over one third of the total will be allocated to a new main frame computer.

11. BRITISH AIRWAYS

Table B.11.1

| | £ million estimated outturn prices (Change on Cmnd 8175 in brackets) | | | |
|--|---|---|----------|---------|
| | 1981-82 (Provisional outturn) | 1982-83 | 1983-84 | 1984-85 |
| <u>Capital Requirements</u> | | | | |
| 1. Fixed assets in UK | 205(+1) | 243(-15) | 348(-17) | 367 |
| 2. Other | -5(-8) | 9(+9) | 4(+3) | 7 |
| TOTAL (1+2) | 200(-7) | 222(-42) | 352(-14) | 374 |
| <u>Financed by</u> | | | | |
| 3. Internal resources | 99(-7) | 172(+41) | 228(+18) | 275 |
| 4. Grants | - (0) | - (0) | - (0) | - |
| 5. Leasing | -8(0) | -9(-17) | -10(-10) | -10 |
| 6. Short-term borrowing | - (0) | - (0) | - (0) | - |
| 7. Long and medium term borrowing | | | | |
| a) market | 99(0) | 85(-40) | 124(-32) | 99 |
| b) PDC | 10(0) | 10(+10) | 10(+10) | 10 |
| <u>Total external finance</u> | | | | |
| (4+5+6+7) | 101(0) | 86(-47) | 124(-32) | 99 |
| 8. Industries general inflation assumption (%) | 13% | 13% | 13% | 11% |
| (Change on Cmnd 8175 attributable to this) | | +11 | +23 | +35 |
| MEMORANDUM | | | | |
| 9. Assumed increase in payroll (%) | 5.6 | 10.8 | 8.4 | 7.0 |
| 10. Assumed increase tariff (%) | | 2% pa less than average rate of inflation | | |
| 11. Performance against target | 0.8 | 0.9 | 4.7 | 4.1 |
| 6% pa on mean net assets revalued at replacement cost for three years 1979-80 to 1981-82 | | | | |

1. The prospects and proposed financing requirements for British Airways (BA) should be regarded as more uncertain than usual because we have not yet received BA's 1981 corporate plan (the first by the present Chairman), which is expected in September.

Outlook and Market Prospects

2. BA's immediate prospects are not good. The international civil aviation market is currently in a severe recession, and both traffic and revenue per passenger-mile have been additionally affected by increasing competition. BA are also disadvantaged by the relatively high level of staffing compared with most of their competitors. Demand is assumed to grow at an average of only 2 per cent per annum over the 5 years from 1980-81 compared with assumed growth last year of 6½ per cent per annum.

Investment plans

3. BA's existing strategy is based, as last year, on the assumption that international airline competition and the proportion of low fare leisure travel will both increase. They have aimed to continue to serve all market sectors and to maintain current market share. The most important element of BA's investment plan is the continuation of their aircraft fleet replacement programme. They have 4 Tristar 200s and 3 Boeing 737s on order for 1981-82, and 19 Boeing 757s and 4 Boeing 747s on order for 1982-83 to 1984-85. These aircraft all represent previously committed expenditure. However, BA have recently sold two of the 747s, resulting in cash savings of £85 million across the IFR period, and the IFR figures have been revised accordingly. (They may also seek a buyer for a third 747). BA's only other planned investments are a further Tristar 200, essential non-aircraft expenditure (which BA aim to keep to no more than 25 per cent of aircraft expenditure) and progress payments for aircraft due for delivery after 1984-85. These investment plans are intended to assist BA to operate more efficiently and cheaply, by phasing out old aircraft with high fuel consumption as well as aircraft which will not meet the new noise regulations due to come into force in 1986, in favour of more fuel-efficient and quieter aircraft. BA require all aircraft investment (including a 25 per cent loading to cover non-aircraft related expenditure) to earn at least 5 per cent real rate of return.

4. The figures allow for a level of expenditure on progress payments for aircraft to be delivered after 1984-85 about 30 per cent below the level which BA put forward in their IFR submission. This saving has been used to reduce the EFLs for 1982-83 and 1983-84 by a corresponding amount compared with the levels contained in the White Paper, while the figures for 1984-85 have been reduced by half this amount. BA themselves regard this reduction as further reducing their long term profitability and as likely to lead to a loss of market share as they may have insufficient capacity if present traffic forecasts are realised.

Financing

5. BA will report a pretax historic cost loss of about £140m for 1980-81. Their financial target requires an average 6 per cent CCA return over the three years from 1979-80 to 1981-82. Last year's loss combined with very low profits in the previous year mean that it will be impossible to achieve their financial target average over the three years. Their current cost return forecast for 1981-82 is only 0.8 per cent.

6. The 1980-81 loss resulted mainly from a £400m decline in revenue which could not be fully offset by operating cost reductions or cost-cutting measures. Due to a large committed capital programme this led to pressure on the EFL, which despite some asset sales, had to be increased by £85m in January 1981.

7. BA have derived their forecasts of future profitability from an initial assumption that the external financing figures based on Cmnd 8175 will not be exceeded. These imply a return to operating profitability in 1981/82 (£38m), rising steadily thereafter (£72m, £174m, £245m in the following years). This means however that detailed forecasts of internal resources for the IFR period have not been made, and in particular that no separate cost and revenue projections have been prepared for the years after 1981/82: these will not be available until after the Corporate Plan has been produced. This in turn means that we have no real basis on which to challenge the realism of the projections. Nevertheless, there must be doubts about whether the required level of profits can be achieved, based on what we know already about their assumptions on costs and revenues. BA are assuming revenue per unit of travel (yields) will fall by 2 per cent per year in real terms, while they expect their fuel costs to rise by 3 per cent in real terms. Productivity is planned to rise by an average of 7.4 per year after 1981-82 and given BA's policy of no compulsory redundancies a higher rate of increase does not seem practicable. These assumptions appear to make it extremely difficult for the profitability forecasts to be achieved.

8. British Airways are seeking total net external finance for 1981-82 to 1984-85 of £410m, in relation to a capital expenditure programme of £1133m (giving a self-financing ratio of 60 per cent). This amount is lower in each survey year than the provision in Cmnd 8175. BA have already been issued with £10m PDC in respect of 1981-82; and similar payments are assumed for future years. All other financing requirements will be met by borrowing, mainly overseas, or, when suitable and favourable opportunities arise, by aircraft finance leases.

Financing Constraints

9. It is clear from the above that BA will have to operate very efficiently indeed, and substantially reduce costs, in order to achieve the financial projections in the IFR.

addition they have cut back planned capital expenditure beyond the levels planned last year in their effort to live within the level of external finance agreed in last year's public expenditure exercise. Moreover these EFLs have been further reduced by further cut-backs in progress payments for aircraft for delivery after 1984-85. In theory it might be possible for BA to defer some capital expenditure still further on new aircraft but this would force them to operate much less fuel-efficient aircraft for longer periods or alternatively lose market share, with the result that BA's profitability could well be reduced. There is also virtually no scope for raising prices more than they currently plan, because of the internationally competitive environment in which they operate. British Airways have already sold two new B747 aircraft. They may be able to sell a third, but the full financial implications of this have not been evaluated.

12. BRITISH AIRPORTS AUTHORITY

Table B.12.1

£ million estimated outturn prices
(Change on Cmnd 8175 in brackets)

| | 1981-82 | 1982-83 | 1983-84 | 1984-85 |
|--|----------|----------|----------|---------|
| <u>Capital Requirements</u> | | | | |
| 1. Fixed assets in UK | 106(+11) | 167(-3) | 190(+59) | 221 |
| 2. Other | -23(-25) | 10(-7) | 4(-12) | -23 |
| TOTAL (1+2) | 83(-14) | 177(-10) | 194(+47) | 198 |
| <u>Financed by</u> | | | | |
| 3. Internal resources | 69(-14) | 116(+1) | 139(+10) | 163 |
| 4. Grants | 1(0) | - (0) | - (0) | - |
| 5. Leasing | - (0) | - (0) | - (0) | - |
| 6. Short-term borrowing | - (0) | 1) | 1) | 2 |
| 7. Long and medium term borrowing | 13(0) | 60) | 54) | 33 |
| | |) (-11) |) (+37) | |
| <u>Total external finance</u> | | | | |
| (4+5+6+7) | 14(0) | 61(-11) | 55(+37) | 35 |
| 8. Industries general inflation assumption (%) | 13% | 10% | 10% | 7½% |
| (Change on Cmnd 8175 attributable to this) | (-) | (+3) | (+1) | (+2) |

MEMORANDUM

| | | | | |
|---|-------|------|-------|-------|
| 9. Assumed increase in paybill (%) | 11.1% | 9.5% | 11.6% | 12.5% |
| 10. Assumed increase tariff (%) | 12% | 10% | 10% | 10% |
| 11. Performance against target | 3.4% | 4.5% | 5.3% | 5.9% |
| (6% CCA on net assets, but including interest receivable over 3 years 1980-81 to 1982-83) | | | | |

Outlook and Market Prospects

1. In 1980-81 there was a small overall fall in demand and for 1981-82 the BAA forecasts no significant change in passenger traffic although Gatwick is expected to continue the above-average increases in demand experienced in recent years. The pattern of growth

previously forecast for the mid-1980's is now expected to be delayed by about a year as a result of the current economic recession; this means that serious over-loading of the present terminals at Heathrow is somewhat less likely before new capacity comes on stream in 1985. The longer term forecasts are for continued growth during the second half of the 1980's and into the 1990's.

Investment plans

2. The Authority's bid for fixed capital expenditure for the three years 1982/83 to 1984/85 has risen by 32 per cent in cash terms compared with Cmnd 8175; and since its bid for 1982/83 shows a small reduction, this growth is concentrated in the final 2 years of the Survey period. During this period the Authority will be seeking to create the additional capacity at its South East airports called for in the Secretary of State's Statement on airports policy in December 1979. The investment programme is thus overwhelmingly related to growth, about 90 per cent on new mostly revenue earning profitable investment and the balance on replacement of existing life expired assets; it is based for planning purposes on the BAA's central traffic forecasts.

3. The programme consists of four major areas of expenditure which over the period on present plans account for over 60 per cent of the expenditure on new investment. These are:

- (a) projects aimed at relieving the present congestion at Heathrow until the fourth terminal is available in 1985;
- (b) completion of projects designed to increase capacity of Gatwick's terminal facilities to 16 million passengers per annum;
- (c) building the fourth terminal at Heathrow to increase the airport's capacity in 1985 to 38 million passengers per annum. Total expenditure within the survey period will be £242m cash and this accounts for 85 per cent of total works;
- (d) building the first phase of a second terminal at Gatwick (subject to the forthcoming planning decision) to increase its capacity in 1986 by about 4 million passengers per annum (followed by phased expansion in subsequent years until the airport reaches a maximum capacity of 25mppa in the 1990's). Total expenditure within the period will be £113 million and this accounts for 44 per cent of total works.

4. Work on Terminal 4 at Heathrow has now started but because of the delay in obtaining detailed planning clearance the expenditure is higher than forecast due to price increases and more heavily biased towards the later years of the Survey. Because of the changes in traffic forecasts the opening of Gatwick Terminal 2 has now been delayed for one year until 1986. As a result the expenditure over the period will be lower than forecast last year. No substantial expenditure on Stansted is included in this Survey period.

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5. The balance of the investment programme covers a considerable number of small projects at both the South East and Scottish airports. Although some of these are concerned with essential replacement of life expired assets most are intended to generate commercial revenue and to improve the flow of traffic and standards of passenger service. This part of the programme accounts for the major part of the increased overall bid in the later PES years: many of the projects included have been deferred as a result of the financing constraints of the last 2 or 3 years.

6. Taking commercial revenue into account, the Authority expects to earn better than the 5 per cent required rate of return on all its capital investments. Delaying the most profitable projects could therefore affect the ability to achieve the forecast level of internal resources.

Financing

7. Despite a small overall fall in demand, the BAA was able in 1980-81 to keep within its external financing limit and achieved a 5.9 per cent adjusted CCA return on net assets, which compares favourably with the financial target of 6.0 per cent average over the three years 1980-81 to 1982-83. There were however special factors (including a higher than forecast amount of interest receivable) and the Authority are only forecasting returns of 3.7 per cent and 4.5 per cent in the remaining target years, leading to an average shortfall of 1.5 per cent. At the Scottish Airports, the Authority now expects to achieve by 1982-83 the aggregate CCA break-even target agreed with Government.

8. The Authority raised its charges by 35 per cent on average in 1980, a considerable real increase which is now the subject of legal action by a number of foreign airlines; this year, except in Scotland, where a real increase in charges has been made, its charges at the South East airports have been increased roughly in line with inflation each year. Although traffic growth and hence revenue is lower than forecast last year, internal resources over the years 1982-83 to 1984-85 remain broadly the same, principally due to tax relief from higher capital allowances, and these are expected to provide 73 per cent of the finance required.

9. The Authority is seeking total external finance over the three future years of the IFR, of £151 million. Although in the year 1982/83 the Authority has been able to reduce its requirement by £11 million, its total bid is an increase of £42 million on Cmnd 8175. Should traffic be at the level of BAA's lower forecasts this would reduce internal resources by a total of £26 million, but this would be more than offset by the £160 million short-term reduction in fixed asset investment. The BAA's capital investment programme is almost entirely devoted to new civil construction. The cost of new construction index has consistently increased at a much faster rate than retail inflation. The Authority believe this pattern will persist with the result that the agreed inflation factors for PES purposes will

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involve a large and growing reduction in the real level of investment assumed in Cmnd 8175 over the IFR period without compensating adjustments.

Financing Constraints

10. The scope for reducing the external financing requirement by further increases in charges is limited as a result of the current legal action by airlines. The BAA have already agreed to a cut in their initial IFR cash bid in 1982/83 to 1984/85 of £14 million, £20 million and £30 million respectively. This requires deferring less urgent capital investment. On BAA's traffic growth assumptions, there is no scope for further cutting the major items in the BAA's investment programme. Department of Trade and Treasury officials agree that there may need to be some re-phasing of capital expenditure in the later years of the IFR period if anticipated growth fails to materialise, but Department of Trade officials believe that it would be premature, given the long lead times for new airport construction, and the uncertainties surrounding future traffic growth, to take such decisions now.

13. BRITISH RAIL

Table B.13.1

| | 1980-81 (provisional outturn) | 1981-82 | 1982-83 | 1983-84 | 1984-85 |
|---|-------------------------------------|------------|--------------|--------------|---------|
| £ million estimated outturn prices (Change on Cmnd 8175 in brackets) | | | | | |
| <u>Capital Requirements</u> | | | | | |
| Fixed assets in UK | 334 (-8) | 348 (-34) | 455 (-6) | 540 (+43) | 600 |
| Other Capital | | | | | |
| Requirements (Revenue | | | | | |
| Investment) | -113 | -123 | -149 | -198 | -227 |
| |) (-8) |) (-27) |) (-7) |) (-72) | |
| Other | -25 | -1 | - | - | - |
| Total 1+2 | 196 (-16) | 224 (-61) | 306 (-13) | 342 (-29) | 373 |
| <u>Financed by</u> | | | | | |
| Internal resources | -594 (-16) | -688 (-53) | -738 (-239) | -755 (-264) | -795 |
| Grants | 669 (-4) | 787 (+7) | 950 (+156) | 1,034 (+192) | 1,120 |
| Leasing | 22) |) |) |) |) |
| Short-term borrowing | 58) (+4) | 125* (+38) | (+80)) |) |) |
| Long and medium term |)) |) | 94 (+70)) | 63 (+43)) | 48 |
| borrowing | 41)) |) | 94) |) |) |
| <u>Total external financing</u> | | | | | |
| (4+5+6+7) | 790 (-) | 912* (+45) | 1,044 (+226) | 1097 (+235) | 1,168 |
| <u>Industries general</u> | | | | | |
| <u>inflation assumptions</u> | | | | | |
| (%) | | | 9.7 | 8.8 | 8.2 |
| <u>(Change on Cmnd 8175</u> | | | | | |
| <u>attributable to this)</u> | | | | | |
| | | | +6 | +30 | - |
| <u>MEMORANDUM</u> | | | | | |
| <u>Assumed increase in</u> | | | | | |
| <u>paybill (%)</u> | | | | | |
| | | 8.3 | 8.3 | 8.8 | 9.2 |
| <u>Assumed increase in</u> | | | | | |
| <u>tariff (%)</u> | | | | | |
| | | 10.4 | 9.7 | 8.8 | 8.2 |
| <u>Performance against</u> | | | | | |
| <u>target</u> | | | | | |
| NO SINGLE TARGET | | | | | |
| Targets for individual businesses under review | | | | | |

* Excludes £52m available for parcels - take up not yet certain.
The financing figures for 1981-82 are given on the basis of Cmnd 8175 grant provision.
Grant requirement above ceiling is shown as met by additional borrowing.

BRITISH RAILWAYS BOARD

Outlook/Market Prospects

The outlook for BRB's businesses in the short term is gloomy. The fall in traffic experienced in 1980 has continued into 1981 and the Board has had to revise its forecasts to take account of this.

2. The Department's papers on the commercial businesses that were produced for the recent CPRS review incorporated more pessimistic forecasts of long-term trends than those used by the Board. These papers made it clear that both the Inter-City and freight sectors are well short of their financial targets and unlikely to meet the test of covering all their costs and showing a 5 per cent real return on investment by 1985. The Secretary of State's statement to the House in June on main line electrification emphasised that the future of the rail freight business depends on reducing its costs by major improvements in productivity and eliminating uneconomic capacity; otherwise it will continue to shrink. As regards Inter-City, the Board have been asked to bring forward plans for a business that will achieve a fully commercial performance by 1985; and to start on the necessary changes immediately.

3. The Board has already taken some steps to match capacity to demand by reducing the length and frequency of passenger trains and so increasing load factors. The Board are forecasting a real reduction of 7 per cent (1982 over 1981) in the costs of train operation. The scope for further economies of this kind is being examined. Productivity improvements and cost cutting exercises are being vigorously pursued: the Ashford works is to close and 1,000 jobs are to be abolished in BREL; more than 4,000 other staff are to be shed in 1981 and some 10,500 in 1982. But such measures will not be sufficient to offset the effects of the severe recession in traffic.

Investment

4. The investment levels shown in the table above are lower than those put forward by the Board in their own submission. They include some provision for electrification of some main lines which Ministers have agreed must be linked to productivity improvements and a viable commercial future for the lines in question. (The Board has been invited to submit a ten year programme of the most profitable electrification schemes). The financing requirement shown assumes that improvement in the performance of the commercial businesses and the necessary productivity gains will avoid the need for additional finance for these electrification schemes, which are estimated to cost £35 million in 1983-84 and £50 million in 1984-85.

5. The figures also exclude any provision for work associated with the Channel Tunnel or the development of Stansted Airport. If either went ahead sizeable investment might be required during the review period. Provision is however included for work on the Victoria-Gatwick rail link.

6. To implement the Government's declared policy of maintaining a network of roughly the present size the Department accepts that the Board must spend more on track and signalling renewals than it has done in recent years. Should spending remain at the current depressed level there would be a deterioration in services caused by signalling failures and speed restrictions and, eventually closures of services on grounds of safety will become inevitable. The figures allow for expenditure on some major structures such as the Barmouth viaduct. Similarly, if rural branch lines are to be operated efficiently in the long term it will be necessary to press ahead with the development of low cost technology and the figures are assumed to cater for the demonstration project associated with the net rail-bus.

7. In determining an appropriate level of investment, the Department has reduced the Board's provision for new rolling stock. This implies more refurbishment of existing stock and an increase in average ages, especially of the freight locomotive and electric multiple unit (EMU) fleets. Within the provision for new multiple units work is planned to begin in 1984-85 on a new build of diesel multiple units (DMU's) to replace the ageing vehicles built in the late 1950s and early 1960s. The figures do not provide for a separate proposal, of which the Board are as yet unaware, for the DHU built to be undertaken by outside suppliers (Metro-Cammell) starting in 1983, 2 years earlier than the Board's proposed starting date. The benefits of this would be for Metro-Cammell rather than the Board, because it would fill a gap in orders which they will otherwise face in 1983 and 1984. The additional cost of bringing forward the programme in this way would be £43 million in 1983-84 and £46 million in 1984-85.

8. Investment in the Board's subsidiary businesses is expected to amount to some £180 million over the review period. Privatisation of subsidiaries could remove some of this and the associated financing requirement from the Board's figures but further privatisation cannot be relied on at this stage.

Financing

9. The figures for internal resources illustrate the deterioration in the Board's trading position since last year and the effect of the recent revisions in forecasting assumptions. The position could be even worse if the Board is unable to hold to its budget assumption of

an 8 per cent pay increase in 1981, and an increase 2 per cent below inflation in 1982. Every 1 per cent increase above 8 per cent would cost the Board some £16 million a year. On the experience of 1980, it seems unlikely that revenue could be significantly improved by real price increases except, perhaps, for the captive commuter market. Even this is at risk if the GLC press ahead with their proposed reductions in London Transport fares. If implemented as planned on 4 October, the Board estimate that these proposals could cost BR some £5 million in lost revenue during the remainder of 1981, some £15 million in a full year and by 1985 some £50 million a year.

10. The bulk of the recent losses of receipts have been on the passenger side and, to the extent that these cannot be offset by management action, they should be met by an increase in the Public Service Obligation (PSO) grant rather than by borrowing. The figures above reflect this from 1982-83. ^{The Department believe} that there is no prospect of meeting the existing planning figures for external finance in 1982-83 and 1983-84, which ^{they believe} are wholly unrealistic since they were set before the impact of the recession was known and were not changed in last year's IFR.

Financing Constraints

11. If the total of external finance had to be reduced further, without affecting the investment or renewals expenditure provided for, possibilities for some savings would lie in fares increases but this would be very limited. For illustration, an additional real increase in London commuter fares of 5 per cent on 30 November 1981 would yield about £13 million in a full year. Closures of some passenger lines would be inevitable. As an example the continuing cost of the Cambrian Coast line is at least £2 million a year but because of the statutory procedures for closure little of this could be saved in 1982-83 unless the Board suspended services for safety reasons.

12. On investment and renewal, the position is that in 1981 the Board have reduced expenditure on track and signalling maintenance and renewal by £57 million below the level which in 1979 and 1980 they had already judged inadequate. Rolling stock renewal was cut by £17 million, bringing the total engineering cut to over £70 million. The 1982-83 figures assume that only part of this cut is recovered in that year, thus increasing the backlog of renewals still further. For the remainder of the investment programme, cancellation of the Jumbo ferries would save perhaps £5 million in 1982-83; cancellation of now deferred APT would save only £2.5 million in 1984-85. A decision, in the face of financing constraints, not to proceed with a build of Mark III coaches would reduce the requirement by £12 million in 1982-83, £28 million in 1983-84 and £29 million in 1984-85.

13. The very limited scope for savings means that it is highly likely, on past experience, that the impact of tighter financing constraints, in particular for 1982-83 would fall on track and signalling renewal which is vital to the long-term future of the network.

14. BRITISH TRANSPORT DOCKS BOARD

Table B.14.1

| | | £ million estimated outturn prices (Change on Cmnd 8175 in brackets) | | | |
|-------------------------------|---|---|--------------|--------------|------------|
| | | 1981-82 | 1982-83 | 1983-84 | 1984-85 |
| <u>Capital Requirements</u> | | | | | |
| 1. | Fixed assets in UK | 11.2(-1.8) | 15.3(-8.6) | 17.2(-9.0) | 19.3 |
| 2. | Other | 2.0(-) | 2.0(-0.5) | 2.0(-0.3) | 2.0 |
| | TOTAL (1+2) | 13.2(-4.8) | 17.3(-9.1) | 19.2(-9.3) | 21.3 |
| <u>Financed by</u> | | | | | |
| 3. | Internal resources | 18.2(-.8) | 22.1(-12.7) | 24.3(-12.2) | 26.8 |
| 4. | Grants | - | - | - | - |
| 5. | Leasing | - | - | - | - |
| 6. | Short-term borrowing | -5.0(-) |) |) |) |
| 7. | Long and medium term borrowing | - |) -4.8(+3.6) |) -5.1(+2.9) |) -5.5 |
| <u>Total external finance</u> | | | | | |
| | (4+5+6+7) | -5.0(-) | -4.8(+3.6) | -5.1(+2.9) | -5.5 |
| 8. | Industries general inflation assumption (%) | 10 | 9 | 8 | 7 |
| | (Change on Cmnd 8175 attributable to this) | | -0.5 | -0.6 | |
| <u>MEMORANDUM</u> | | | | | |
| 9. | Assumed increase in paybill (%) | 8 | 9 | 8 | 7 |
| 10. | Assumed increase tariff (%) | 10 | 9 | 8 | 7 |
| 11. | Performance against target (Target 20% return on assets by 1980) Figure achieved 1980: 9.9% Forecast cca return on net assets | 2.0%(1981) | 1.9%(1982) | 1.8%(1983) | 1.9%(1984) |

Recent Developments

1. 1980-81 was a bad year for BTDB. Traffic was heavily hit by the recession and the

seamen's strike, while an industrial dispute at Southampton caused a severe deterioration in the final quarter. In addition BSC withheld payment of some £2.5 million due during the year; this is now the subject of litigation. Despite a cut of almost 50 per cent in proposed investment, BTDB missed its EFL of £10 million by £10.5 million. The Board's latest forecast suggests that it will also have difficulty meeting its EFL for 1981-82 of £5 million, partly because of the continuing dispute at Southampton. The Chief Secretary agreed, exceptionally, that an offsetting reduction should not be made in the Board's 1981-82 EFL on condition that they took measures to meet their existing limit. The recession also prevented the Board from meeting their financial target of a 20 per cent return on assets after historic cost depreciation. A return of 9.9 per cent was achieved in 1980 which, in the circumstances, can be regarded as a considerable achievement.

2. Legislation is well-advanced to enable privatisation of the Board. It is hoped to sell a 49 per cent stake in November 1981 to secure this aim, although final decisions on when to float shares must await consideration of the Board's latest results and profits forecasts. Preliminary indications are not encouraging; and the danger of further prejudicing the possibilities for disposal needs to be borne in mind in considering the Board's financing figures.

Investment

3. BTDB's investment programme is not large. It consists of two broad categories; replacement of structures and facilities required to keep its ports open (eg lock gates) and customer demand schemes. The Board looks for a guaranteed return on customer demand schemes and will not undertake them unless their expected rate of return is at least 20 per cent on a DCF basis. Approaches from customers seeking new facilities reduce significantly in 1981-82 and most of the investment cuts were in the allocation set aside for these schemes. Only a small allowance for new customer demand schemes - around £2 million pa - has been left in the forecasts of investment in future years. This means that the bulk of BTDB's annual investment of some £15 million a year will be on replacement schemes required to maintain current levels of activity.

Financing

4. In the past, BTDB has recorded healthy profits and has been able to make sizeable early repayments of its debt to the Government. However, faced with a big drop in turnover due to the recession the Board can do little to maintain its profit levels. Costs cannot readily be cut because so much of the infrastructure cost is fixed and because the Board is prevented by the National Dock Labour Scheme from shedding surplus labour quickly. Price increases have been imposed but have had to be limited because of competition from other ports (some of them supported by Government grant, others outside the Dock Labour

Scheme). There are few surplus assets which can be sold. Investment has been cut but this has not been sufficient to outweigh the loss of traffic.

5. Prospects are very much dependent on the state of the economy generally. The Board's figures take a fairly pessimistic view of the future figures with only a slow recovery from the recession. A strong economic recovery would therefore bring a marked improvement over forecast profit levels in the later years.

6. On the Board's assumptions, its annual financing requirement would remain steady at about -£5 million. If flotation does not take place this Autumn, it will be necessary to consider to what extent the Exchequer should benefit from the continuing surplus projected by the Board by means of further early repayments of NLF debt.

Financing Constraints

7. As explained above, there is little scope for increasing internal resources further. There is perhaps £1 million-£1½ million of investment which could be deferred or cancelled in 1982-83, though this would be counter productive if it inhibited customer demand schemes. These cuts would eliminate only half the projected excess over Cmnd 8175 in 1982-83. The Board is likely strongly to resist cuts beyond this level.

8. The present figures involve at least two areas of risk. One is the possibility of a major emergency expense due to equipment failure or accident and another is the possibility that the Board will not be able to raise prices in line with inflation, because of competition from other ports some of which benefit from Government or local authority subsidies. No provision has been made for these eventualities.

15. BRITISH WATERWAYS BOARD

Table B.15.1

| | £ million estimated outturn prices (Change on Cmnd 8175 in brackets) | | | |
|---|---|---------------|---------------|--------------|
| | 1981-82 | 1982-83 | 1983-84 | 1984-85 |
| <u>Capital Requirements</u> | | | | |
| 1. Fixed assets in UK | 6.5(+0.5) | 7.1(+3.5) | 8.0(+4.2) | 8.6 |
| 2. Other | -0.8(-0.8) | 1.0(+1.0) | 0.1(+0.1) | - |
| TOTAL (1+2) | 5.7(-0.3) | 8.1(+4.5) | 8.1(+4.3) | 8.6 |
| <u>Financed by</u> | | | | |
| 3. Internal resources | -26.0(+0.3) | -32.5(-3.8) | -35.5(-5.1) | -37.2 |
| 4. Grants | 28.5(-) | 34.4(+3.8) | 37.0(+4.5) | 38.8 |
| 5. Leasing | 1.0(-) | 0.7(+0.3) | 0.7(+0.3) | 0.7 |
| 6. Short-term borrowing | - (-) | - (-) | - (-) | - (-) |
| 7. Long and medium term borrowing | 2.2(-0.7) | 5.5(+4.2) | 5.9(+4.6) | 6.3 |
| <u>Total external finance</u> | | | | |
| (4+5+6+7) | 31.7(-) | 40.6(+8.3) | 43.6(+9.4) | 45.8(+9.9) |
| 8. Industries general inflation assumption (Change on Cmnd 8175 attributable to this) | 12½% (-0.6) | 10% (+0.4) | 7½% (+1.0) | 5% (+1.1) |
| <u>MEMORANDUM</u> | | | | |
| 9. Assumed increase in paybill (%) | 7½-10% | 9½% | 7% | 4½% |
| 10. Assumed increase tariff (%) | 12½% | 10% | 7½% | 5% |
| 11. Performance against target | Not Applicable | | | |

1. The British Waterways Board maintains the nation's canals and operates some associated services - drainage, water supply and the movement of freight. It is unusual amongst nationalised industries in that most of its activities are non-commercial and consequently grant aided - grant accounts for about 90 per cent of its total external finance. The proportion of investment which can be appraised against commercial criteria and which

is the subject of this review is correspondingly small.

Outlook/market prospects

2. The nature of the business has precluded the setting of a financial target. The Board's general financial objective, described in Cmnd 7131, is to break even after grant. Work on developing performance aims continues. The large proportion of external financing represented by deficit grant tends to make expenditure plans by BWB grant dependent rather than programme driven.

3. Turnover on most of the main commercial activities is expected to rise broadly in line with GDP. This comprises relatively constant profits on property estates, water rates and recreational activity despite a 1/3 drop in hire cruiser bookings for the immediate season. However the prospects for freight activity are more uncertain. Freight services moved into an overall loss of £0.41 million for 1980-81 and the prospects for immediate recovery are limited. This raises questions about the future of the business which will need to be pursued in the coming year.

4. BWB estimate that arrears of maintenance exist amounting to £120 million plus £21 million on reservoirs, bridges and tunnels for which there are statutory responsibilities regarding public safety. BWB consider that additional finance should be made available in recognition of the risks to public safety from depressed levels of revenue expenditure. On the other hand, the Board's own record in according priority to this area of expenditure has not been good.

5. Concern with efficiency and costs has led to proposals for a consultants' study of market prospects and of the efficiency and cost effectiveness of the entire BWB operation and the scope for rationalisation. These are under discussion with the Chairman.

Investment Plans

6. BWB have maintained their limited programme of commercial investment at the expense of maintenance expenditure in the face of cuts in external financing limits imposed in 1979 and 1980. The investment plans presented here represent in full the Board's view of the investment necessary in both commercial activities and in the replacement and maintenance of non-commercial assets. Full details and investment appraisals for these plans have yet to be presented to DOE, although within them a case has been made and approval given to investment in the Sheffield and South Yorkshire Navigation (SSYN) project which is to be completed in 1983. The Department of the Environment believe that BWB should be able to borrow to finance essential maintenance equipment replacement since replacement would enable the Board to operate more efficiently and thus generate increased freight and recreational revenue from improved maintenance of the waterway system.

7. The Treasury view is that in the absence of investment appraisals substantiating that belief higher borrowing figures should not be included in the resources table. If increased expenditure on non-commercial maintenance work and equipment is necessary, increased capital grant should be given to the Board. This would be for consideration within the context of the Public Expenditure Survey and Programme 8.

8. Restriction of borrowing to the one commercial project for which an investment appraisal has been made, the SSYN, and to a limited amount of investment in joint venture and customer related schemes, for example, the Aire & Calder Canal, would result in the following reduction in the borrowing figures shown in Table B.15.2:

Table B.15.2

| | £m (outturn prices) | | |
|--------------------------------|---------------------|---------|---------|
| | 1982-83 | 1983-84 | 1984-85 |
| Long and medium term borrowing | -4.2 | -4.6 | -4.9 |

Financing

9. Income other than grant is estimated to be £15.3 million in 1981. This is projected to increase to £25 million in 1985. The Board have assumed that wage costs for 1981 will rise in the order of 7-10 per cent at a July settlement date. This is considered to imply unit labour costs rising slightly less quickly than inflation generally although these, taken with an increased manpower level, will bring a 23 per cent pay bill increase from 1980-81. This increase in the pay bill underlies the concern about the Board's efficiency and costs which has led to consideration of a study by management consultants, and work to devise performance measures before the extra resources which the Board argue they require are committed.

10. The greater part (77 per cent) of the Board's income is composed of grant. With regard to the Board's independent sources of revenue, BWB have aggressive estates and charging policies but these sources of income are limited in relation to their extensive maintenance commitments to the canal network and associated structures. Faced with the present downturn in freight activity they are redeploying some staff onto maintenance but are constrained in further action by the short term costs of redundancy payments and the rigidities of the dock labour scheme. Their projections assume that cost increases will be recouped through increased prices but the present depressed state of the market makes it difficult to make such increases without loss of competitiveness.

Financing Constraints and Option Cuts

11. The majority of the Board's external financing is borne by grant aid from programme 8 and options for future levels will be considered within the context of preliminary stages of the Public Expenditure Survey. Grant aid for EWB has been cut in previous years and the Board have made commensurate cuts in their engineers' maintenance programmes. However they point to their statutory responsibilities to keep the system in working order and to maintain structures such as reservoirs and bridges to standards which meet public safety requirements. Further cuts are likely to add to long term problems and increase the mounting backlog of maintenance.

12. Of the small proportion of investment properly financed by borrowing, a large proportion is already committed on the scheme to improve the Sheffield and South Yorkshire canal which is now nearing completion. A smaller project totalling some £0.6 million on the Aire and Calder canal is planned but not yet committed.

13. The Board have property holdings but prefer not to dispose of them in the absence of a commitment from Government to increase grant to make good the loss of rental income which would result from sales.

16. NATIONAL FREIGHT COMPANY LIMITED

Table B.16.1

| | £ million estimated outturn prices (Change on Cmnd 8175 in brackets) | | | |
|--|---|-------------|-------------|---------|
| | 1981-82 | 1982-83 | 1983-84 | 1984-85 |
| <u>Capital Requirements</u> | | | | |
| 1. Fixed assets in UK | 43.4(-) | 44.8(-12.1) | 48.3(-8.0) | 53.2 |
| 2. Other | 3.2(-) | 1.5(-3.0) | 2.9(-2.7) | 3.2 |
| TOTAL (1+2) | 46.6(-) | 46.3(-15.1) | 51.2(-10.7) | 56.4 |
| <u>Financed by</u> | | | | |
| 3. Internal resources | 40.9(-) | 46.7(-16.7) | 49.9(-14.5) | 53.2 |
| 4. Grants | 2.6(+1.0) | 1.6(+0.1) | 1.6(+0.1) | 1.6 |
| 5. Leasing | 2.2) | 3.6) | 5.5) | 5.3 |
| 6. Short-term borrowing |)(-1.0) |)(+1.3) |)(+3.7) | |
| | 0.9) | -5.6) | -5.8) | -3.7 |
| 7. Long and medium term borrowing | - (-1.3) | - | - | - |
| <u>Total external finance</u> | | | | |
| (4+5+6+7) | 5.7(-1.3) | -0.4(+1.4) | 1.3(+3.8) | 3.2 |
| 8. Industries general inflation assumption (%) | 11 | 10 | 10 | 11 |
| (Change on Cmnd 8175 attributable to this) | - | 0.1 | 0.7 | - |
| <u>MEMORANDUM</u> | | | | |
| 9. Assumed increase in paybill (%) | 9 | 7 | 12 | 11 |
| 10. Assumed increase tariff (%) | 11 | 10 | 10 | 11 |
| 11. Performance against target (no target) | - | - | - | - |

Recent Developments

1. The former National Freight Corporation was wound up on 30 September 1980 and a new company, National Freight Company Limited was formed. This was in preparation for the privatisation of the undertaking. The NFC's debt to the Secretary of State for Transport

(amounting to £100 million) was written off in return for shares in the new company. The Secretary of State is currently the sole shareholder but is considering an offer from the management of the Company to purchase them.

2. The road haulage industry has been hard hit by the recession and significant over-capacity in the industry has made it impossible to raise charges in line with costs. NFCL's parcels business has been particularly hard hit and a major reorganisation of its two main parcels-carrying subsidiaries, Roadline and National Carriers Limited, is being carried out. This has been precipitated in part by a decision by British Rail to close down its Collected and Delivered (C&D) parcels services, for which NFCL was a major sub-contractor. Overall the Company expects to reduce its workforce from 31,000 to 26,000 during the course of 1981 and its vehicle fleet from 16,000 to 13,000. Despite the difficult trading conditions, NFCL met its EFL in 1980-81 and expects to do so again in 1981-82.

Investment

3. Investment is expected to remain roughly constant over the planning period at around £35-40 million (1980-81 prices). For investment planning purposes, the Company divides its operations into three categories: "priority" (ie high growth potential); "intermediate" and "problem". Over two thirds of proposed investment over the period 1981-4 is in the priority category with only the minimum of essential renewals in the problem areas, which are contracting. The Company is looking for DCF returns of 25 per cent and upwards for investment in the priority areas. With privatisation in mind, preference is given to projects offering a good return in the short term.

4. The Company's submission included provision for investment in undertakings overseas. Such investments require special authorisation by the Secretary of State for Transport which is unlikely to be given. The relevant sums (rising to some £3 million a year) have been deducted from the figures shown above. The Company regards overseas investment as a top priority: in the event of a decision to authorise the overseas investment programme, they would be likely to defer other investments in order to find money to fund the overseas activities.

Financing

5. NFCL's financing requirements have been pushed up in the short term by the costs of disengaging from their unprofitable parcels operations (£13 million was added to the EFL for 1981-82 to help them deal with this). However, the Company is expected to move into current cost operating profit in 1982-83 with assets sales providing a further boost to internal resources.

6. Although the creation of NFCL brought with it the right for the new Company to borrow in the markets, it is envisaged that the company will become a net lender of funds. The main positive component of its external finance is vehicle leasing. Grants have been phased out with the exception of a small sum in respect of travel concessions to former British Rail employees, which is passed straight on to British Rail.

7. The pattern of financing in later years will be affected by the precise size and timing of dividend payments; these are deducted from internal resources and will have to be restricted if the previous planning figures for external finance are to be met. There are advantages in terms of flotation in encouraging NFCL to pay dividends, which are, of course, payable to the Secretary of State as sole shareholder. However, it is considered unlikely that NFCL will be able to pay a dividend of £5 million in 1982-83 as they assume in their forecasts. This payment has therefore been excluded from the figures shown above.

Financing Constraints

8. NFCL have been making good progress in cutting costs through redundancies and reorganisations; scope for further improvements over and above those already planned must be limited, though it might be possible to accelerate the rundown of the parcels sector; an immediate closure option is to be reviewed in late June/early July. This would however mean heavier costs (and more external finance) in 1982-83 but increased profits in later years. These effects will be easier to quantify after the review has taken place.

9. The Company hopes to be able to increase prices in line with inflation but, in a highly competitive industry, significant real price increases are unlikely to be possible. Dividends in later years could be cut from the planned level of £8.5 million in 1983-84 and £9.5 million in 1984-85.

10. Investment could be cut if necessary, but this would seriously undermine future profits and viability. The long term prospects for the Company (and for its flotation) are crucially dependent on the move out of old products and into new areas with growth potential. The overseas element of new investment, which NFCL expected to bring large and speedy returns, has already been removed.

17. NATIONAL BUS COMPANY

Table B.17.1

£ million estimated outturn prices
(Change on Cmnd 8175 in brackets)

| | 1981-82 | 1982-83 | 1983-84 | 1984-85 |
|--|-----------|---------------|---------------|-----------|
| <u>Capital Requirements</u> | | | | |
| 1. Fixed assets in UK | 54(+2) | 66(-27.2) | 81(-21.0) | 91 |
| 2. Other | 5(-2) | 6(+3.2) | 6(+2.9) | 7 |
| TOTAL (1+2) | 59(-) | 72(-24.0) | 87(-18.1) | 98 |
| <u>Financed by</u> | | | | |
| 3. Internal resources | -16(-) | -9.6(-29.7) | -1.6(-23.8) | 11.3 |
| 4. Grants | 60(-) | 58(-1.3) | 64(+7.3) | 64 |
| 5. Leasing | 7.5) | 21.1) | 15) | 18 |
| 6. Short-term borrowing |))(-) |)) (+7.0) |)) (-1.6) | - |
| 7. Long and medium term borrowing |) 7.5) |) 2.5) |) 9.6) | 4.7 |
| <u>Total external finance</u> | | | | |
| (4+5+6+7) | 75(-) | 81.6(+5.7) | 88.6(+5.7) | 86.7 |
| 8. Industries general inflation assumption (%) | 14 | 12 | 11 | 10 |
| (Change on Cmnd 8175 attributable to this) | | +10 | +16 | |
| <u>MEMORANDUM</u> | | | | |
| 9. Assumed increase in paybill (%) | 1 | 7 | 7 | 8 |
| 10. Assumed increase tariff (%) | 14 | 12 | 17 | 17 |
| 11. Performance against target: | | | | |
| a. target path | - | 0%(1982) | 25%(1983) | 60%(1984) |
| b. latest forecast | - | 0% | 25% | 60% |

Figures represent agreed proportion of 1985 target fulfilled in each calendar year

(£18.5m profit at 1980 prices, on cca basis, after grant and before interest)

Recent Developments

1. The last year has seen major cuts in NBC's services and staff levels in the face of declining passenger numbers due to the recession. These cuts enabled NBC to meet their EFL for 1980-81 despite a drop of £25 million in forecast profits but further cuts will be needed to meet this year's EFL.
2. A medium term financial target for NBC was announced in May 1981. The target is to earn by 1985 a current cost operating surplus of £18.5 million at 1980 prices (£28.8m in 1985 on the basis of NBC's inflation assumptions). This is a larger surplus than would be required to meet the RRR on new investment, although smaller than the surplus required to meet the RRR on all capital employed. Its achievement will require a substantial improvement over the £20 million current cost loss in 1980. Progress towards the target will be dependent on NBC's ability to raise real fares, reduce service levels and costs and secure local authority revenue support for unremunerative services, at a time when the recession is eroding traffic. Substantial reductions in the level of local bus services will be necessary.
3. In contrast to the difficulties facing stage carriage services, which form well over 90 per cent of NBC's undertaking, the National Express long distance services have had a very successful year. Both passenger carryings and receipts have increased markedly since the Transport Act 1980, which came into force on 6 October, removed licensing restrictions on all express services. It is too early to be certain whether this will lead to a sustained improvement in profitability, but the signs so far are encouraging.

Investment

4. 85-90 per cent of the Company's investment is in new vehicles to replace those which are worn out. The investment permits some reduction in labour costs through greater one-man operation, but is primarily justified as necessary to maintain the business. Any quality improvements reflect the requirements of safety and other regulations rather than NBC specifications except in the case of the express coaching business, where higher quality vehicles may be justified by the prospective commercial return.
5. The fleet replacements forecast by the Company - settling at 950 a year - show a substantial reduction from the 1260 a year of last year's forecasts. The reduction results from extending vehicle lives and reducing total fleet size by 23 per cent from end 1979 level reflecting the recession and the declining future for local bus services.
6. The lower financing requirement resulting from reduced investment is modified by the assumption adopted by NBC that the real cost of vehicles will increase by 4 per cent a year in line with historical trends. Further work has been set in hand with the company to

consider whether this trend is likely to continue and to look at likely future capital and maintenance costs of vehicles and what this implies for the trade-off between capital and maintenance expenditure and fleet size.

7. Low vehicle acquisitions in 1982-83 are offset by an exceptional item of £10 million representing the capitalised value of part of NBC's property at Victoria.

Financing

8. Even to stand still will require an improved performance from NBC since New Bus Grant (worth about £25 million to NBC in 1980-81) will be phased out for all operators over the review period. The new financial target requires a significant additional improvement over current levels of profitability. Local authority grants are an important element of NBC's finances; the existing figures are broadly in line with the assumed level of local authority transport expenditure contained in Cmnd 8175. Although reductions in local authority grants will generally result in reductions in the services concerned, the time lag between withdrawal of grant and service cuts and the short term costs of withdrawals can have a significant effect on the company's finances.

9. NBC's plans imply a gradual decline in financing requirements in real terms. However, their relatively high inflation assumptions lead to a rising profile in cash terms and an increase on the revalued Cmnd 8175 figures.

Financing Constraints

10. Further constraints would lead to more service cuts (particularly severe if there were concurrent cuts in local authority revenue support or concessionary fares payments). The Company believes that any attempt to impose real fares increases in the early years would be counter productive because it would erode the revenue base. There is almost no scope for further cuts in investment. In the later years service reductions may lead to a lower vehicle requirement which might enable some investment to be deferred.

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18. SCOTTISH TRANSPORT GROUP

Table B.18.1

| | £ million estimated outturn prices (Change on Cmnd 8175 in brackets) | | | |
|--|---|-------------|--------------|-----------|
| | 1981-82 | 1982-83 | 1983-84 | 1984-85 |
| <u>Capital Requirements</u> | | | | |
| 1. Fixed assets in UK | 14.0(-1.7) | 14.0(-1.1) | 15.0(-2.0) | 14.2 |
| 2. Other | -0.1(+0.5) | 0.9(+1.3) | 1.0(+1.3) | 1.1 |
| TOTAL (1+2) | 13.9(-1.2) | 14.9(+0.2) | 16.0(-0.7) | 15.3 |
| <u>Financed by</u> | | | | |
| 3. Internal resources | -2.2(-0.6) | -11.1(-9.1) | -12.9(-13.1) | -15.1 |
| 4. Grants | 20.4(-1.5) | 27.0(+5.4) | 29.3(+7.2) | 32.1 |
| 5. Leasing | | | | |
| 6. Short-term borrowing | -1.5(+0.9) | -0.3(+2.0) | 1.2(+2.9) | -1.3 |
| 7. Long and medium term borrowing | -2.8(-) | -0.7(+1.8) | -1.6(+2.3) | -0.4 |
| <u>Total external finance</u> | | | | |
| (4+5+6+7) | 16.1(-0.6) | 26(+9.2) | 28.9(+12.4) | 30.4 |
| 8. Industries general inflation assumption (%) | 8%-12% | 8%-10% | 8%-10% | 8%-10% |
| (Change on Cmnd 8175 attributable to this) | (-0.3) | (+1.0) | (+0.4) | (+0.7) |
| MEMORANDUM | | | | |
| 9. Assumed increase in paybill (%) | 7½% | 7½% | 7½% | 7½% |
| 10. Assumed increase tariff (%) | | | | |
| 11. Performance against target: | | | | |
| a. target path (£m) | 5.1(1981) | 5.7(1982) | 6.5(1983) | 7.2(1984) |
| b. latest forecast | 5.8* | 5.7 | 6.5 | 7.2 |

[Bus group target is cca profit after grant and before interest of an average rate of return of 4½ per cent per annum on net fixed assets over period to 1983].

*Notes Recoups 1980 shortfall

1. The Scottish Transport Group runs bus services throughout Scotland, except in the 4 main cities; shipping and haulage services on the West Coast of Scotland; and a number of

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ancillary, travel-related activities. The bus operations account for some 83 per cent of the Group's total turnover of around £143 million. Around 11 per cent of turnover comes from Ferry Services and the balance from haulage and ancillary activities.

Outlook

2. In December 1980 a new medium term financial target was set for the bus Group to make a current cost operating profit amounting to an average rate of return of 41 per annum of net fixed assets over the period to 1983. The target is equivalent to meeting the full RRR on new assets. Targets for other parts of the business were unchanged: ferry operations are expected to break even after grant; haulage and ancillary services are to make a surplus of at least 8 per cent on turnover.

3. The bus Group experienced a sharp decline in traffic over the past year. This is expected to moderate in 1981-82 although the long term downward trend in bus traffic will continue. The Group performed well in difficult circumstances but fell marginally short (by £0.6 million) of meeting its target in 1980. It plans to recoup this shortfall in 1981 although trading conditions may make it difficult to redress the shortfall in the space of one year.

Investment Plans

4. The object of the Group's investment is to replace existing assets consistent with projected trends in traffic. The bulk of the investment is required to finance the purchase of new buses. Reorganisation of services following a comprehensive market analysis exercise is expected to reduce the overall fleet requirement by some 15 per cent. While the review assumes a reduction in strength by end 1982, slippage in the programme may result in the retention of older buses. In order to achieve an orderly purchase and replacement pattern the Group proposes to tailor its investment to the new fleet size but to achieve the fleet reduction by disposal of its oldest vehicles. The Group envisages no difficulty in achieving the required rate of return.

5. The table takes no account of new investment in replacement tonnage for the Group's shipping operations. The Group has twice proposed the inclusion of this expenditure in the annual review and its effect in forward years can be summarised as follows:

Table B.18.2

| | 1982-83 | 1983-84 | 1984-85 |
|--------------------------------|---------|---------|---------|
| Fixed assets | | | |
| Internal resources | +3.0 | +6.7 | +8.4 |
| Short-term borrowing | -0.1 | +0.4 | +2.1 |
| Long and medium term borrowing | -1.1 | +0.8 | +1.6 |
| Total External finance | +4.2 | +5.5 | +4.7 |
| | +3.1 | +6.3 | +6.3 |
| | (8 -) | | |

Until decisions have been taken on the structure of government assistance to ferry services in future years, investment in new tonnage is difficult to justify. Ministers should be aware, however, that in the light of the policy adopted and taking account of the Group's justification for its proposals, agreement may be sought in the course of the year to a variation in the Group's 1982-83 EFL to accommodate additional investment.

Financing

6. The financing requirement projected by the Group exceeds that in Cmnd 8175 by a relatively large margin. There are 5 reasons for this. The major factor is the considerably higher level of local authority support which it is now assumed will be forthcoming. The Group does not itself determine these grants which count as external finance. STG has projected both a 10 per cent increase in real terms in local authority revenue support together with an additional £5 million from Lothian Region in 1982 (inflated for subsequent years). This contrasts with last year's forecast of 5 per cent real term increase. Second, the Group desires broadly to maintain its present capital structure by further NLF borrowing whereas the Cmnd 8175 assumption was that STG would repay £4 million of loan capital in 1983-84 without further recourse to the NLF, implying a cash generation requirement well above target in that year. Third, the Group have felt it necessary to improve their liquidity and this is reflected in additional provision each year for working capital. Fourth, smaller than previously anticipated depreciation allowances have reduced internal resources. Finally, following a marketing study conducted in 1980, the Group are planning to reduce the overall size of their bus fleet by 15 per cent over the period of the review. The reduction in net fixed assets affects the profit level required to meet the financial target.

7. The Group's main working assumption is that it will generate the level of surplus necessary to finance its capital investment and meet its financial targets; costs will be cut or fares increased as necessary to do so. Lower levels of inflation are assumed than in last year's review with capital costs running somewhat ahead of general inflation in the light of past experience. On the basis of the figures set out in the table, fares increases would be expected to be contained well within the 8 per cent general inflation rate projected by the Group, but different levels of regional revenue support can be expected to result in differential fares increases/reductions.

Financing constraints

8. STG's freedom of action is severely constrained by the fact that its investment programme is geared to replacement of its fixed assets. A short term reduction in its financing limit of perhaps £1 million might be met by a squeeze on working capital, or by a reduction in the Group's liquidity. In the longer term, it could only be met by raising its rate of return on capital employed.

9. There may be some scope for limited savings (say £1 million in each year) on fixed investment if older vehicles were retained by the Scottish Bus Group. A reduction of the Group's vehicle intake could be expected to have repercussions in later years and would be vigorously opposed by the Group's management, but could have a marginal impact in restraining fares increases. There is comparatively little scope for current cost economies greater than those which already underlie the table.

10. Of crucial importance for the overall financing limit is the level of local authority revenue support which is projected in the table at approximately £17 million in 1982 rising to £22.7 million in 1984, compared with £8.6 million in 1980. The Secretary of State for Scotland declined to increase the 1981-82 EFL to accommodate higher local authority support proposed by Lothian Region after the EFL for that year had been fixed. Continued limitation of revenue support would not, however, affect the Group's requirement for finance and reductions would need to be recouped from fares revenue.

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APPENDIX B
SECTION 19

19. BRITISH SHIPBUILDERS

Table B.19.1

| | £ million estimated outturn prices (Change on Cmnd 8175 in brackets) | | | |
|--|---|-------------------------------------|----------------|---------|
| | 1981-82 | 1982-83 | 1983-84 | 1984-85 |
| <u>Capital Requirements</u> | | | | |
| 1. Fixed assets in UK | 39(+9) | 60(+21) | 92(+42) | 120 |
| 2. Other | 28(-22) | 60(+40) | 65(+60) | 16 |
| TOTAL (1+2) | 67(-13) | 120(+61) | 157(+102) | 136 |
| <u>Financed by</u> | | | | |
| 3. Internal resources | -84(-14) | -27(+3) | +21(+21) | +48 |
| 4. Grants | 62(+19) | 55(+11) | 37(+3) | 14 |
| 5. Leasing | 1(+1) | 1(+1) | 1(+1) | 1 |
| 6. Short-term borrowing | - | - | - | - |
| 7. Long and medium term borrowing | 88(-19) | 91(+46) | 98(+77) | 73 |
| <u>Total external finance</u> | | | | |
| (4+5+6+7) | 151(+1) | 147(+58) | 136(+81) | 88 |
| 8. Industries general inflation assumption (%) | 9.8% | 8.0% | 7.8% | 7.8% |
| (Change on Cmnd 8175 attributable to this) | -3 | -1 | 0 | - |
| <u>MEMORANDUM</u> | | | | |
| 9. Assumed increase in payroll (%) | 7% | 7% | 7% | 7% |
| 10. Assumed increase in tariff (%) | | | | |
| | | | Not applicable | |
| 11. Performance against target | Loss as target of £25m after crediting IF. (This equals £75m loss before IF credit) | Target not set for subsequent years | | |

General

The IFR figures were supplied by BS in advance of their 1981 Corporate Plan and assume that MOD orders and exports of warships will be sufficient to avoid disruption in the

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warshipbuilding division, and that merchant and offshore orders will be available on terms which will permit an improving financial performance. Until the MOD picture on future requirements is clear, and the Government has decided on its response to BS's Corporate Plan, these estimates must be regarded as highly uncertain. Further contraction in the industry would increase costs to Government.

Outlook/Market Prospects

As noted above BS's market prospects for naval orders depend upon the outcome of the Defence Expenditure Review. The market for merchant ships is forecast to turn up in 1982, and continue rising throughout the review period, but BS's ability to secure orders at reducing levels of subsidy will depend upon the development of world shipbuilding prices which are in general determined by Japan. The outlook for offshore orders is uncertain and the market is erratic; a major prospective order from Occidental which was recently shelved has been replaced by another major order from another buyer within a short space of time. Treasury officials believe that the 1981 Corporate Plan's assumptions on both merchant shipbuilding and offshore orders are too optimistic, both as to volume and to price.

BS are currently forecasting that they will be within their loss targets for the current financial year, but their EFL could be in jeopardy as a result of the possible effect of Polish Debt Rescheduling on the Polish Ships Deal which could cost BS up to £12 million per year in lost receipts during the period of rescheduling.

Investment Plans

BS's investment plans will have to be reviewed in the context of their Corporate Plan. The figures in the IFR are thus provisional. They include capital expenditure for the Trident programme which is the subject of separate financial scrutiny by the Department of Industry. The breakdown is as follows:-

Table B.19.2

£m outturn prices

| | 81-82 | 82-83 | 83-84 | 84-85 |
|---------|-------|-------|-------|-------|
| Trident | 3 | 14 | 36 | 54 |
| Other | 36 | 46 | 56 | 66 |
| Total | 39 | 60 | 92 | 120 |

Financing

In November 1980 a revised EFL of £185 million (originally £120 million) was announced. The increase was needed because of the shortfall in MOD orders, the costs of the steel strike

and of under-utilisation. At the same time it was announced that the loss target of £90 million (before crediting Interest Fund grants) was likely to be exceeded by £20 million. BS finished the year £7 million within the revised EFL and exceeded the loss target by exactly £20 million.

As noted above the forecasts are highly uncertain, and subject to review as part of the Government's scrutiny of BS's Corporate Plan. No change in the method of external financing is envisaged but special arrangements may be necessary for the Trident project.

Financing Constraints

The scope for reducing BS's external financing requirements will be considered in the review of BS's Corporate Plan.