PART 4

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Policy towards the Nationalised Industries

Financial Control : Privatisation.

NATIONALISED INDUSTRIES

Pt 1 May 1979

Pt 4 March '81

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Cabinet / Cabinet Committee Documents

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E (81) 79	22.7.81
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E (DL) (81) 2nd Meeting, Minute 2	10.6.81
E (NF) (81) 3	21.5.81
E (NF) (81) 2	12.6.81
E (NF) (81) 1st Meeting, Minutes 1 and 2	2.7.81
E (81) 26th Meeting, Minutes	31.7.81
E (NF) (81) 4	8.9.81
E (NF) (81) 2nd Meeting, Minutes	18.9.81

The documents listed above, which were enclosed on this file, have been removed and destroyed. Such documents are the responsibility of the Cabinet Office. When released they are available in the appropriate **CAB** (CABINET OFFICE) CLASSES

Signed P Wayland Date 9 August 2011

PREM Records Team

Published Papers

The following published paper(s) enclosed on this file have been removed and destroyed. Copies may be found elsewhere in The National Archives.

House of Commons: Eighth Report from Treasury and Civil Service Committee, Session 1980-81: Financing of the Nationalised Industries, volume 1 (report) and volume 3 (appendices)
Published by HMSO, 12 August 1981

Signed C A Wayland Date 9 August 2011

PREM Records Team

Nat Ind (9)

PRIME MINISTER

MBM

21/9

THE RELATIONSHIP BETWEEN GOVERNMENT AND THE NATIONALISED INDUSTRIES

In your minute (M11/81) of 4 August you invited those of us concerned with nationalised industries to give you proposals by 18 September for providing new arrangements to establish quickly and effectively a true business culture in our Departments which would make for better understanding and communication between us and our nationalised industries. I have only had a short time to assess the needs of the Department of Transport against the background of our August 4 discussion. But my first impression is that an incoming businessman will find an extremely positive atmosphere in which to work and in which he could reinforce the "change of culture" which is so clearly needed in all departments.

In the Department of Transport the relationships between our nationalised industries, including those which are to go private, are in the charge of a single Deputy Secretary. But other parts of my Department are also concerned with industry in various ways, for example with the Channel Tunnel as a venture for private finance, with the road-building industry and with the assistance of the export markets of all our industries which produce equipment for transport. So I can offer to an incoming businessman of high calibre a wide range of interests. I certainly want to have one in.

This would not be a novelty for this Department. I understand that for the past five years there has been a succession of three highly competent young city accountants serving in the Department. The Department set out to recruit them just before they were due to become Partners, when they would have moved out of our financial range as we have seen it up to now. They have not been advisers, nor line managers, but they have been thoroughly involved in the day to day work. One of them, for example, was closely involved in setting up Sealink with a company structure within British Rail; and another has been deeply involved in the privatisation of the National Freight Company. But whereas these accountants have served at Assistant Secretary level, I should want to go higher with the businessman and place him alongside the Under Secretary in charge of the Railways Directorate where most of his time will be needed. I would use him to guide and to use the analytical side of the Directorate, which already includes economists, accountants and statisticians and provides the information for understanding and constructively examining the performance and management of the railway. But I would need to keep my administrators' service in much its present form to handle legislation and finance and to help me to form and give effect to our policies.

I think we may have to pay quite a lot to get a businessman of the required calibre, and I do not think that anything is served by attributing some particular Civil Service rank to him. What will be important is that his role and his involvement should be made absolutely clear to him and to my staff - though, because of the working model we already have with the accountants, I do not expect this to be difficult.

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I am very glad that we are to have a new Ministerial Committee to consider issues of nationalised industries policy. As I said at our meeting on August 4 when speaking with the Energy Department in mind, I consider this Committee, plus the appropriate business reinforcements we propose in Departments, should make a major contribution to the 'change of culture' which has to be achieved.

I am sending copies of this minute to Geoffrey Howe, Patrick Jenkin, George Younger, John Biffen, Janet Young, Nigel Lawson, and also to Sir Robert Armstrong and Mr Ibbs.

DJ 14.

DAVID HOWELL

18 September 1981

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SECRETARY OF STATE FOR SCOTLAND

SCOTTISH OFFICE
WHITEHALL, LONDON SW1A 2AU

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Prime Minister

CPRS REPORT ON THE RELATIONSHIP BETWEEN GOVERNMENT AND THE NATIONALISED INDUSTRIES

In your personal minute M11/81 of 4 August to the Secretary of State for Trade you asked sponsoring Ministers to put forward proposals for improving the expertise and understanding of their Departments in dealing with their nationalised industries.

2. The Scottish Office is the sponsoring Department for three nationalised industries - the North of Scotland Hydro-Electric Board, the South of Scotland Electricity Board and the Scottish Transport Group. Each of these I regard as being in the category of smaller nationalised industries which were not explicitly considered by the CPRS study. I think it important to make this point for, in my view, a number of the problems which the study identified have not arisen, or are less serious, in the case of the industries' sponsored by me. I have not, for instance, been confronted with unexpected demands for additional finance and I do not regard the lack of mutual trust and understanding described by the CPRS as a fair reflection of attitudes in Scotland.

3. On the particular objectives set out in your minute, I agree that a greater degree of business expertise will improve the ability of staff in my Departments to probe and weigh up the arguments put forward by the industries. The industries with which I am concerned are however engaged in highly specialised fields and therefore differ greatly from the typical private concern. To monitor and control their activities with greater authority would, therefore, require highly specialised rather than general business expertise. Where, through direct entry schemes or otherwise, we recruit staff with some general business experience, we try to place them within the Scottish Office where that experience will be of greatest use. We could, in theory, go further and train a small number of staff to equip them with the specific expertise for nationalised industry work by selecting those with suitable backgrounds and by arranging for their secondment to nationalised industries, private sector companies and relevant businesses or consulting firms. But it would not be possible to offer the staff selected a satisfactory career structure within the Scottish Office in posts dealing full-time with nationalised industry affairs for there are only five such posts within the Office. Additionally, if a net increase in staff were to be avoided, it would be necessary for the secondees, on their return to my Departments, to spend a considerable proportion of their time, as the existing staff do, on day-to-day duties which would not draw on their experience. I am very much aware, however, of the need to strengthen our expertise in dealing with the nationalised industries. Arrangements already exist for the exchange of staff on secondment between outside employers and the Scottish Office and some

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successful links with the nationalised industries have already been made through this scheme. The present manpower cuts in the Civil Service necessarily impose some constraint on how quickly we can develop the secondment programme but, we hope to make increasing use of secondment to place Scottish Office staff in suitable posts in the nationalised industries and to offer reciprocal Central Government experience to nationalised industry employees, to enable both sides to draw upon the experience gained in the future.

4. As regards the decision that staff dealing with nationalised industry matters should remain longer in post, the need to ensure that staff stay in post long enough to gain necessary depth of knowledge and experience and that their careers are developed along sensible lines applies to every aspect of my Departments' operations, not only nationalised industries. In the Scottish Office it has been the aim for some time to achieve longer posting periods and there has been a fair measure of success in this area. But this desirable objective has to be balanced against the need to give the most promising officers as wide a range of jobs as is reasonable to ensure the proper development of their careers. The Scottish Office posts which deal with nationalised industries are frequently filled by staff with previous experience of dealing with those industries.

5. I am conscious of the need to build up our expertise in dealing with nationalised industries. With this in mind, steps will be taken to strengthen the links between the administrators in the nationalised industry field and their economic and accounting advisers and the importance of previous experience in the financial or business area will be borne in mind in future postings. I will also consider the possibility of drawing where necessary on any more specialised expertise introduced into the relevant parts of the Department of Transport and the Department of Energy.

6. I am sending a copy of this minute to the recipients of yours.

(Approved by the Secretary of State
and signed in his absence.)

18 September 1981

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COPY NO 30

THE RELATIONSHIP BETWEEN GOVERNMENT AND THE NATIONALISED INDUSTRIES

A Report by the

Central Policy Review Staff

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THE RELATIONSHIP BETWEEN GOVERNMENT AND NATIONALISED INDUSTRIES

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THE RELATIONSHIP BETWEEN GOVERNMENT AND NATIONALISED INDUSTRIES

A. INTRODUCTION

The CPRS was invited to review:-

- what should be the basis of the relationship between Government on the one hand and nationalised industries (and companies dependent on financial support from Government) on the other;

- how best to give effect to that relationship so as to ensure a reasonable balance between the commercial responsibilities of the Boards, and the supervisory responsibilities and financial commitments of the Government;

- the adequacy of the present arrangements for monitoring the financial performance of the industries and for giving early warning of troubles ahead.

The remit did not include consideration of either privatisation or the financing of the industries. However quickly privatisation proceeds, a number of industries will still be nationalised, anyway for years to come. So the problems of Government/industry relations will remain.

2. We have discussed these questions with Ministers concerned, with present and past nationalised industry* Chairmen and Board members, with officials at all levels in Departments and with a limited number of academics and private sector businessmen. Because of the short time for the study (2-3 months), we restricted discussions in the main to the larger public enterprises (BSC, NCB, BGC, BL, BRB, BT, Electricity Council, CEGB). However, we believe our findings and recommendations apply generally. But in implementing them it will be essential to keep in view the special features of particular industries. Because of the short time available, the CPRS has not been able to carry the discussion of all its recommendations to the point where they can be implemented at once. If Ministers endorse the principles, more detailed work will be needed in several areas.

*In this report the term 'nationalised industries' includes those companies dependent on financial support from the Government (BL, RR) as well as the statutory corporations.

B. THE PROBLEM

3. Our discussions showed that a number of problems are perceived in the present arrangements. The problem that has caused most concern recently is the poor financial performance of many of the industries. Most of the other problems are not new - they have been discussed in other major studies over the past twenty years:

(i) Lack of clear objectives. Governments have not given the industries clear objectives, and this has contributed to the need for constant detailed Government intervention. Chairmen told us that the Government had never given them a clear remit, within which they could try to run their industries efficiently. They found that priorities were often determined by short-run tactical considerations, at odds with the commercial interests and longer-term timescales of their industries. Hence common purpose is lacking, despite some good individual relationships on a personal level, and accountability is blurred.

(ii) Lack of mutual trust and understanding. Some Ministers and officials feel that they are not given full information, or early warning of potential problems, on a basis of mutual frankness and trust. On the other side the industries complain about lack of understanding and expertise within Departments. The Government sees the Boards as weak and inefficient, while the industries resent detailed intervention.

(iii) Lack of market forces. Many of the industries have monopoly power, so that financial targets cannot guarantee their efficiency. For most of them there is no realistic danger of bankruptcy, so that their managers do not have the same pressure to improve their performance as they would in the private sector. Ad hoc efficiency studies by the Monopolies and Mergers Commission (MMC), as presently constituted, are not a sufficient substitute.

(iv) Lack of motivation. From the Government's point of view there is a lack of any effective sanction against industries which fail to meet targets. Public embarrassment is effectively the only tool available, since sacking Chairmen or whole Boards would be a drastic step. On the other side the industries see themselves as subjected to public

criticism from all sides, but not often given credit publicly for their successes. Furthermore they feel that many of their difficulties arise from factors outside their control, such as the state of the economy but that Ministers and officials do not understand this properly. Chairmen feel that the climate makes it harder for them to exercise effective leadership.

(v) Extent of union power. In some industries the unions have established a dominant position, not only in pay bargaining but in wider issues affecting the industry's future.

(vi) Shocks. Ministers are concerned that a number of industries (BSC, BL and NCB) have made demands for finance substantially in excess of the levels foreseen. By the time these demands were put before Ministers, often at short notice, there was in effect no option but reluctantly to concede them.

(vii) Institutions. In our interviews we invited opinions on each of the main institutions involved - the industries, the sponsor Departments and the Treasury. Comments were almost always critical, which perhaps shows the strains in the current relationship. The industries themselves were criticised both for being too inbred and narrow in outlook, and for being too monolithic so that information and decision-making is too centralised. Being in the middle the sponsor Departments were criticised from both sides; by the industries for being ineffective in discussions with the Treasury, which made some industries want to negotiate direct; by the Treasury and others for not being tough or knowledgeable enough in negotiating with the industries. The main criticism of the Treasury was that it was financially too rigid and understood too little the effects of this on the industries.

(viii) Allocation of resources. A concern of Treasury Ministers and officials was that within Whitehall there seems no efficient system for ensuring that investment, and indeed the overall use of resources, is assessed consistently both within and between industries. Resorting to across-the-board cuts in EFLs as a method of allocating resources seems an admission of defeat in establishing priorities.

4. This summary of the problems is not exhaustive but we believe substantially covers the key perceived shortcomings in the present relationship. We shall have something to say about each of these problems and believe that our recommendations provide a sound basis for solving some and improving others. There is no perfect answer.

5. At the outset we need to distinguish between real problems and secondary symptoms. The CPRS believes that the poor performance of the nationalised industries over the past decades has five fundamental causes :-

(i) the lack of market forces and of any threat of bankruptcy;

(ii) the extent of union power;

(iii) the absence of a sufficient strategic framework;

(iv) the impact of political decisions which unavoidably clash with straightforward business objectives;

(v) a failure of communication and understanding.

6. These lie at the root of the difficulties. For instance, if union power is a problem in a particular industry it is not enough to have a close relationship between Chairman and Secretary of State, and a rational system for allocating resources or for monitoring and forewarning of problems, unless the Board and Government use their close relations to evolve a strategy for dealing with the underlying union problem. Similarly changing the administrative organisation within Whitehall will lead to nothing unless managers in the industries are motivated to behave differently; at the end of the day the Government cannot implement policy, it is in the hands of the management of the industries. Any solutions should be aimed at these basic ills.

C. BACKGROUND TO SOLUTIONS

7. Before presenting the CPRS findings and recommendations in detail there are some points to make on the background to possible solutions :-

(i) Diversity of the Nationalised Industries. The wide diversity of the industries is itself a problem - they are in widely different kinds of business, and have differing positions in the market place, from monopoly to highly competitive. This effectively excludes a single solution, but there are some general principles that can be applied, even though the industries' diversity means that great care must be taken in the application.

(ii) Previous Studies. The review covers ground that has been well ploughed before; clearly there is no philosopher's stone that will solve all the problems. The two most recent major studies - the 1968 report from the Select Committee on Nationalised Industries (SCNI) and the 1976 report by the National Economic Development Organisation (NEDO) - include much analysis and diagnosis with which the CPRS agrees. However the solutions fail to attract. More will be said about a Ministry of Nationalised Industries along the lines of the SCNI's proposal later in the paper (see paragraphs 59-62). In the view of the CPRS the NEDO proposal for a Policy Council between the Government and the Boards would in practice add another layer of control which could only further blur accountability and was rightly rejected.

(iii) Foreign Experience. In the course of this study the CPRS briefly reviewed how foreign countries tackled the similar problems posed by their nationalised industries. There are some elements of European experience that seem worth drawing on - for example the French administrative elite which forms a common culture at the top of Government, the Civil Service and industry and the French attempts to make objectives explicit through long-term contracts between the state and the industries. The US use of regulatory agencies to control the public utilities offers a different approach and is considered later (paragraphs 10 and 11). But there is clearly a limit on the extent

to which experience in one country can be applied in another country with a different cultural background.

(iv) Time Constraints. The CPRS was aware in carrying out this Review that solutions were required that could be implemented relatively quickly. Hence we have concentrated as much as possible on changes which could be made without altering the statutory framework of the industries. But however rapidly new measures are implemented, performance can only be expected to improve gradually.

(v) Underlying Problems. This slowness of response is inevitable because first people's behaviour and attitudes will have to change. Moreover, the pace of improvement will turn on the extent to which the industries continue to be affected by deep-seated and pervasive underlying problems, such as the general health of the economy and the extent of union power. The unexpected depth and nature of the 1980 recession was a major reason for the borrowing requirements of the nationalised industries increasing significantly beyond the levels foreshadowed in the Medium-Term Financial Strategy. Over the longer term too, the productivity performance of nationalised industries is likely to be affected by the general economic climate. A better relationship can help in finding ways of dealing with these difficulties, but it will not remove them.

(vi) Line Management. The success of the nationalised industries depends on their line management. The size of many of the industries in itself means that they have problems that demand high quality executive ability for their solution. On top of this there are the further complexities that arise from the interface with Government and some of them have the added dimension of having to cope with very great union power. The task of the Chairmen of the largest industries justifies obtaining the services of the most able industrialists that can be found; at present, because of the known frustrations, and indeed, the poor pay compared with the private sector, it is extremely difficult to attract such people. Any change in the relationship with Government should be aimed at clarifying, simplifying and reducing problems at the interface so that Chairmen can concentrate on running their industries.

Where additional pressures are introduced to increase emphasis on efficiency this must be done in ways which leave the Chairman and his managers unencumbered in the actual task of achieving the improvements; petty interference is extremely harmful. We believe that at all levels the quality of much of the management of the industries is good, but leadership is essential if this is to be put to good effect. The aim must be to ensure that the line management as a whole is actively pursuing the objectives that the Government desires.

D. LONGER-TERM POSSIBILITIES

Competition

8. The best way of improving the industries' industrial performance is to expose them to full competition wherever possible. All Government intervention to influence the behaviour of the State monopolies is in effect a surrogate for market forces, and a second best. How far it is possible to expose the industries, or parts of them, to increased competition needs detailed study, and was not within our terms of reference. But it is important that our proposals should help rather than hinder the process.

Privatisation

9. Where an industry can be exposed to competition, this will make privatisation easier. Again the question of privatisation was outside our terms of reference. But we have had in mind that our proposals should reinforce rather than weaken the pressures towards privatisation.

Regulation

10. Some industries, or parts of industries, have a degree of 'natural monopoly' - in the sense that, given the structure of their products and markets as public utilities, there is no efficient way of arranging for competing sources of supply. These could be returned to the private sector only if some way could be found to ensure that they would not exploit their monopoly power and push up prices to make excessive profits, or cover excessive wages and inefficiency. One answer to this would be the establishment of a regulatory agency (or agencies) to control prices, following the practice in the US referred to earlier.

11. While seeing the attractions of this in principle, the CPRS does not believe that it could offer a comprehensive solution to the problem of Government/industry relations, at least within the next few years. There would be great difficulty in giving the agency clear guidelines and defining its relationship with the Government and the Boards of the industries themselves (as well as with the MMC). It seems to us very doubtful whether the Government could lay down clear rules for determining prices, or agree to leave an independent agency with a wide measure of discretion. Without direct accountability to Government or Parliament, the agency might well ignore broader considerations

(eg energy policy) and give too much weight to special interests (eg consumers). This is discussed at greater length in Annex E. However, we have not had time to study these questions in detail, and Ministers may wish to consider whether they would like further work done to see whether regulation might be useful as a means towards privatisation in suitable industries.

E. BASIC MODEL

12. It is to the strategic management of those industries likely to remain in the public sector for the foreseeable future that the current review addresses itself. At the heart of the relationship with the nationalised industries is the need to strike a balance between the commercial aspirations of the Boards and the broader economic and social concerns that any Government is bound to have.

13. At one extreme is the traditional Morrisonian concept of an 'arm's length' relationship. This is based on the theory that once a Board has been set up, it will itself be best placed to balance the commercial concerns of the industry against the wider national interest. In practice all past experience suggests that this is unrealistic. Although the assets of the nationalised industries are vested in their Boards by statute, and the Minister's formal powers are confined to appointment of Chairmen and Board members and approval of certain key matters, the Government has a major responsibility on behalf of the public to see that they are carried on efficiently and in the public interest. Because nationalised industries play such an important part in the economy and are not fully subject to market forces, Ministers will want to intervene in areas that Boards regard as part 'management' - pay, prices, investment, efficiency - particularly when the Government's other objectives are threatened by unforeseen developments. The immediate response from the industries to Government intervention is to cry foul and argue that short-term expediency puts their longer-term objectives in jeopardy. This blurs accountability.

14. At the other extreme Ministers might take detailed powers to run the industries, almost as if they were Government Departments, for example in the way the Post Office was formerly managed. We have no doubt whatever that this is the wrong model to take. It would give Ministers a detailed responsibility which would force them to intervene in day-to-day management, and would make it impossible for managers to operate on a proper commercial footing. Any changes in working practice or reductions in manpower would risk becoming a direct confrontation between Government and the workforce.

15. The CPRS is convinced that an intermediate model is most appropriate. The Government is effectively the owner of the industry, and this entails setting objectives, pressing for efficiency improvements, monitoring performance and ensuring action to correct shortcomings. The aim must be to restrict intervention as far as possible to matters of strategic direction and performance monitoring, and to avoid management intervention of a detailed kind. We believe that the first step towards achieving this is through a much clearer definition of the objectives for each industry. Intervention should be minimised by clarifying as much as possible in advance. The CPRS solution also seeks to provide a stronger substitute for market forces by making the non-executive directors on nationalised industry Boards a more effective force, and by recommending some changes in the current arrangements for external efficiency audits.

16. If Government is to act effectively as the owner of an industry, it must be well-informed about the underlying business issues. It cannot have the same knowledge of an industry as the Chairman and senior executives, but if there is to be proper understanding and communication, and if the arguments put forward by an industry are to be effectively probed, Government must have the basic business skills. This means that each main sponsor Department needs to contain a small number of experienced businessmen of proven competence including at least one who possesses the ability to run an industry, even though it is not his immediate job to do so. Without people of this kind, however hard professional civil servants try to fill the gap, there is bound to be some lack of understanding, less than fully effective monitoring, some unreal expectations and unnecessary shocks and disappointments. To be effective this will require one businessman at a very senior level in each main sponsor Department, and several people with business skills to support him at lower levels. Clearly most of the present sponsor officials are conscientious and hard working but they need to be better prepared by means of a more specialised career progression and training.

17. Although each Secretary of State has the direct responsibility for his industries, the industries' problems impact on overall Government concerns, for example the PSBR, prices, pay and employment. There is a need for the senior Ministers directly concerned to have a structured forum in which the overall problems and performance of the industries, and financial priorities, can be reviewed. For this to be effective they need the support of a very small review staff which contains top quality business skill of the same kind needed in sponsor Departments.

18. Many of the questions about which such a Committee supported by a review staff should be concerned are at present dealt with ad hoc at short notice, and the scope for improvement is obvious. However, it will be important to ensure that all these new arrangements are confined to major strategic issues and do not develop into interference on matters which are properly the concern of Departments or the industries.

19. Although these are the basic principles of the relationship in the CPRS model, the application will be different for different industries. In principle, the need for Government attention will be less the more profitable and more exposed to market forces an industry is although some of the decisions required may still be extremely difficult. The following paragraphs set out in more detail the analysis behind, and the recommendations of, the CPRS model. They start with the need to set clear objectives for the industries, which is clearly pivotal to the relationship. Next, changes in the industries themselves are considered, and finally changes in the organisation of Government.

F. OBJECTIVES

20. At present the Government does little to set Chairmen and Boards any clear objectives. The CPRS is convinced that this explains a good deal of the resentment aroused by Government intervention, and apparent obstructiveness by some Chairmen to Government policy. Many Chairmen complained to us that they had no clear idea where in strategic terms the Minister wished the industry to go; this has been a feature common to previous studies. Although Chairmen would welcome discussions on strategy it seems that in general Ministers' diaries are too full for wide-ranging strategy discussions. Meetings between Chairmen and Ministers seem more often than not limited to discussion of one crisis or another. Chairmen would prefer to talk through such crisis issues against the backcloth of a coherent set of objectives for the industry - objectives which could for the most part remain stable for a number of years.

21. The CPRS recognises that the definition of objectives for nationalised industries is often more difficult than in the private sector, because the objectives are not solely commercial. Possibly there has also been some reluctance on the part of Ministers to commit themselves to objectives which might be political hostages to fortune. However, the CPRS is convinced that the benefits of setting clear objectives outweigh the disadvantages, and that it is essential that before appointment each Chairman should be given a clear idea of the broad objectives he is to aim for. Appointing the candidate with the best track record is not enough; indeed it can be dangerous in that, without agreed objectives, he could develop the industry in a way which conflicts with the Government's intentions. Ministers might like to ask themselves how many of the present Chairmen and Boards of the largest enterprises (NCB, BL, BSC, BGC, CEGB, BT, BR) are developing the industries in the way Ministers would ideally want? Under present arrangements Ministers have no real sanction over Chairmen once appointed, other than specific directions and ultimately dismissal.

22. The CPRS fully acknowledges that all previous major studies of the nationalised industries have argued for clearer objectives to be set, and that these recommendations have not been adopted by successive Governments. In order to give Ministers a clearer idea what is involved, we put forward in Annex A an illustration of what the objectives might look like in practice.

In general these objectives would incorporate those aims laid down by statute but would interpret these in specific business terms. Mostly the objectives would be qualitative, indicating desired trends, rather than quantitative; Corporate Plans based on the objectives would fill in the detailed figures from year to year.

23. Such a set of objectives should remain reasonably robust over a number of years and would form the basis of the partnership between the Secretary of State and Chairman. Obviously they could not remain totally immutable in a changing environment and would sometimes need updating. If either the industry or the Government wished to change the objectives, then further consultation would be necessary. This would serve to make explicit the consequences of a change in direction. Clearer objectives would also provide a better basis for judging management performance and motivating improvement. Whether such objectives were to be made public or not would be at the discretion of the Secretary of State.

24. In short, the CPRS sees four main advantages in clear objectives for each industry :-

(i) before appointment each Chairman would have agreed to the general direction in which he would develop the industry; this should improve motivation and enable management performance to be better measured;

(ii) decisions potentially at variance with the basic objectives would require renegotiation of the objectives, thus making explicit the consequences of change;

(iii) by setting the guidelines of the relationship they should help to cement a partnership between the Secretary of State and the Chairman thus avoiding the resentment at Government intervention that can arise now;

(iv) by setting objectives in strategic terms, as we propose, there should be a reduced need for Government to intervene in detailed management matters.

Corporate Plan

25. An agreed set of objectives would still mean that there was a lot of hard bargaining to be done around the Corporate Plan. However, the existence

of the objectives should mean a more structured negotiation within given guidelines.

26. The 1978 White Paper put corporate planning at the heart of the relationship between Government and the industries, and envisaged that the Government should become involved in the early stages of each plan. In the present atmosphere of distrust this does not happen. The industries produce one-future plans; officials then comment and explore the detail, but seldom elicit substantial changes. The CPRS believes that only if clear objectives are agreed can options be realistically discussed. Discussion of options will also need more business skills within Whitehall, a subject which is discussed later.

27. Out of the discussion of the Corporate Plan, the aim would be to arrive at a series of medium-term targets and budgets for the ensuing year, tough enough to set the industry a serious challenge but realistic enough for them to try to achieve. Non-commercial services undertaken at Government request would normally be identified and paid for. Financial targets, performance aims and EFLs would be elements in the package.

External Financing Limit

28. For as long as the Government has a central cash target in the PSBR, the CPRS sees no alternative but to monitor the industries also against cash targets, namely EFLs. However, their role needs to be clarified. If unrealistically tight limits are set, they will not serve to motivate management and the system will become discredited, especially if industries start to expect overruns to be topped up from a contingency reserve. The CPRS has a remit from E(NF) to examine the operation of EFLs, and the subject is best left to that report rather than pre-judging the findings here.

Monitoring

29. Clearly once targets have been set progress towards them must be monitored. We have examined some of the systems now used to monitor industries' performance; as a cross-check we have also looked at the systems employed by large private sector companies with diversified holdings. We believe that the system for the nationalised industries could be improved to help with the strategic management of the industries.

A summary of our general proposals is at Annex D. A fuller account will be prepared, with some suggestions for individual industries, and will be made available to officials. It is important to underline that these proposed improvements in monitoring should not impose further burdens on the industries; if their internal management systems are adequate the industries will already have all the data needed.

30. The combination of an improved monitoring system associated with our proposals to introduce more business expertise into Whitehall should lead to better supervision of the industries. Given early warning of potential shortfalls against target, which the new monitoring proposals will provide, it is essential that remedial action is subsequently taken by the industry. Greater business expertise should give Whitehall the ability to distinguish with confidence to what extent any potential shortfall against target is due to factors outside the industry's control. It should also give Whitehall a better understanding of what the commercial consequences of the various remedial options might be and in turn, through development of a common culture with the industries, help Government to persuade management of the appropriate level of response. It is important to emphasise that the system proposed does not mean that Government will be taking management's decisions for them; but rather that unless Government has the necessary business skills it will not be able to judge whether the level of response that the industries are proposing is adequate.

G. THE INDUSTRIES

Overall Structure

31. The sheer size of some of the industries makes them difficult to manage effectively. Many are too monolithic and in appropriate cases need breaking up into more manageable units. Besides leading to direct efficiency gains this could serve to make policy issues more explicit, for instance by exposing cross subsidies. In general, one would like to see sub-units of the industries producing accounts which relate profits to use of assets wherever this seems sensible.

32. There is a particular structural problem for the Electricity Supply Industry in England and Wales. The unwieldy Electricity Council is at present required to meet an EFL without any authority over the area boards and CEGB. In the view of the CPRS this system is unworkable. Progress towards efficiency improvement must start with a change in the present set-up. We recognise that the Department of Energy is considering how the system can be changed and we recommend that they should bring forward proposals as soon as possible.

Board Structure

33. The statutes for the nationalised industries have very little to say on the structure of the boards other than prescribing their minimum and maximum overall size. In many of the public enterprises executive directors outnumber the non-executive directors, a structure presumably modelled on the private sector; however, the CPRS firmly believes that in the nationalised industries a majority of non-executive directors is preferable. In the private sector market disciplines ensure that the executive directors are constantly under pressure to improve performance. In the absence of the threat of bankruptcy in public enterprises executive directors and managers below them are not under the same pressures. The CPRS would like to see on Nationalised Industry Boards a majority of non-executive directors to act as a surrogate for these pressures for greater efficiency in the use of resources and to stop the executives on the board becoming complacent. It seems to the CPRS that non-executive directors stand the best chance to become an effective force if they outnumber the executives; in any event there need to be enough non-executives to be mutually supportive.

But a majority in itself is not enough. They need to be people with sufficient experience, confidence and willingness to press the executive directors effectively to take action on efficiency questions; mostly they should be recruited from those with management experience in large private sector organisations. We have found evidence that many of the present non-executive directors do not exhibit the qualities we describe above.

34. However, such a structure would be ineffective unless the non-executive directors were informed clearly by the Secretary of State of the role they were to fulfil. We do not believe that in the past enough care has been taken to give them a clear indication of what was expected of them. In addition to their general responsibilities determined by statutes, the CPRS believes that the non-executive directors should be charged with certain specific tasks by the Secretary of State. Among these would be:-

(i) to ensure that the industry's objectives are adhered to, but if change becomes necessary that this is negotiated and agreed;

(ii) through the mechanism of a Board Efficiency Audit Committee (see paragraph 36 below)

(a) to take a special interest in the internal efficiency of the industry and ensuring that best management practice is brought in, and

(b) to ensure that external efficiency audits of the type undertaken by the MMC are followed up, ie that management takes the necessary action;

(iii) advising on appointments both executive and non-executive through a Board Appointments Committee (with the Secretary of State of course retaining the ultimate authority for appointments);

(iv) advising on board salaries (once again subject to the Secretary of State's ultimate authority).

35. It is envisaged that the non-executives accompanied by the Chairman would have an annual meeting with the Secretary of State to report on progress towards these specific objectives. Among benefits from such a meeting could be to highlight opportunities for privatisation of subsidiaries or potential joint ventures with the private sector. The meeting would also provide an opportunity to review the relationship with the Department and for the Chairman, supported by his non-executive colleagues, to comment on whether interventions had been constructive and had concentrated on major issues.

36. On efficiency, whilst external audits have a role to play in identifying areas which the Board may have missed, the Board alone has the collective responsibility for efficiency and only it can see clearly the practical obstacles. The CPRS believes that only an effective number of non-executive directors on the Board can combine the general business experience with the opportunity to press the executives towards greater efficiency, for which the Board as a whole carries responsibility. It would not be appropriate for a sponsor Department to attempt to fulfil such a role through external interference. The non-executive directors should constitute an Efficiency Audit Committee. This Committee should press the line management to produce evidence of improvement on all major efficiency issues. In some cases it might be appropriate for one or two high-potential young managers from within the industry to participate in efficiency studies; they would provide the detailed knowledge of the operations in an analogous way to Rayner scrutinies. This in turn would help to inculcate a sense of efficiency within the organisation when these managers return to line management positions. The Efficiency Audit Committee could also press for consultants to be engaged as it saw fit.

37. The CPRS is in principle in favour of small Boards of Directors (7-10 members). The larger the Board, the less the opportunity for constructive discussion and the more the key decision-making devolves to some small group. There are strong arguments therefore for small cohesive Boards on the BL model (three executive, four non-executive members). Clearly a move towards smaller Boards for the public trading sector would ease one of the difficulties in having non-executive directors in the majority on public enterprise Boards, namely the recruitment of sufficient non-executive directors of high enough quality. The usual counter-argument to having a smaller Board is that by restricting the number of executive positions on the Board the motivation of management will be reduced, since a position on the Board is naturally regarded as the pinnacle of a career. However, experience in the US, where in general there are very few executive positions on Boards, seems to undermine this line of argument.

38. If Ministers endorse the general principle of smaller Boards with a majority of non-executive directors, there will be a difficult transitional phase in moving from the current situation. It will not be sufficient to rely on natural wastage. Annex B discusses this further and shows the current membership of the nationalised industry Boards. Only in a small number of cases is the statutory minimum size of the Board at variance with the CPRS recommendations - see Annex B.

Civil Servants on Boards

39. In the context of Board structure, the CPRS has considered the case for having civil servants as non-executive directors on nationalised industry Boards. The general argument in favour is that such arrangements improve mutual understanding between Whitehall and the industries. While not wishing to rule out the possibility in every case, the CPRS is in principle against the concept of civil servants as board members. Having civil servants on the Board can lead to conflicts of loyalty and interfere with the coherence of the Board, which must at the end of the day be collectively responsible for decision-taking. Giving the non-executives a clear task on efficiency will itself put a strain on Board cohesion, but one which ultimate collective responsibility should be able to withstand. However, further pressures should be avoided. Once Board cohesion is broken, strategic decision-making tends to be driven away from the Board to the executive. One advantage claimed for giving civil servants seats on Boards, that it improves their knowledge of the industry, should be secured by our proposals for sponsor Departments (paragraphs 65-76).

Outside Recruitment of Senior Executives

40. Some of the industries (CEGB, BGC, NCB and BT seem prime examples) show classic symptoms of being too inward-looking and inbred. In these industries the CPRS would see some scope to reinforce non-executive directors by appointment of a few outside senior executives in preference to internal candidates. Suitable candidates could be found from people who had previously left the industry to widen their experience. In any event they must be knowledgeable and have relevant skills if they are to have an impact. As another counter to inbreeding executive directors on nationalised industry Boards should be encouraged to take up non-executive directorships in the private sector in order to widen their horizons.

External Efficiency Audits

41. The CPRS believes that external efficiency audits have a vital part to play in complementing the role of non-executive directors in a sustained drive for efficiency in those industries that do not face competition. We consider that some of the references carried out by the Monopolies and Mergers Commission under Section 10 of the Competition Act demonstrate that audits on these lines can be useful. However, implementation rather than recommendations is the real test of the effectiveness of such references. The CPRS believes that more should be done to ensure that recommendations are followed up. We also think that regular audits of a particular industry are necessary in order that the external audit team can become progressively more knowledgeable and therefore incisive.

42. The CPRS recommends that each nationalised industry that is not operating in a fully competitive market should be subject to an external efficiency audit on a regular basis, say every four years, or more frequently if the audit shows this to be needed. The aim will be to form an independent view of the industry's performance, and this will serve two purposes :-

(i) to report on the extent that any findings in previous audits have been followed up;

(ii) to complement the efforts of non-executive directors by opening up the industry for external scrutiny in depth every few years to examine the changing situation and scope for improvements.

We suggest that it should be normal practice before an audit begins, for the sponsor Department to tell the external audit team where they suspect areas of inefficiency.

43. The MMC itself need not have a monopoly of external efficiency auditing of the nationalised industries. It is the body immediately available, and therefore the obvious one to use at present. However, if Ministers decide to explore further the possibility of adopting a regulatory system (see paragraphs 10-11) the best way of ensuring effective and penetrating efficiency audits merits further study.

44. Furthermore some criticisms of the MMC's style of reporting have been brought to our attention. With the exception of their findings against the public interest the MMC give no sense of priorities in their recommendations. Nor do they attempt to quantify potential savings or make proposals for implementation which would allow progress to be monitored. By contrast we were favourably impressed by the approach of one of the management consultancy firms concerned with auditing the efficiency of public utilities in the USA. It appears to operate on a less adversarial basis vis-a-vis management and thereby secures the co-operation and commitment of management to implementing efficiency measures. It may be that the MMC's approach is conditioned by the statutory nature of its references. **Therefore** we recommend that in the more extended programme of efficiency auditing which we propose the opportunity should be taken of allowing such management consultant firms to show what they can do. In this way it will be possible to complement the obvious strength of the MMC with some of the techniques developed by these consultants.

45. We recommend that following external efficiency audit findings the Efficiency Audit Committee on the Board be charged with ensuring that the management has an effective quantified plan for implementing the recommendations. It should also be the responsibility of the Efficiency Audit Committee to check that the savings are achieved.

Chairmen

46. The nationalised industries pose very difficult management problems. The largest are complicated enterprises, comparable in size and complexity with the biggest private sector companies. They often have trade union problems which are greater than any in the private sector, and management is carried out under the constant glare of public scrutiny. The Chairmen are by private sector standards badly paid. It is therefore important to keep in mind the factors motivating them, and to support them in the job they are doing.

47. The appointment of the right Chairmen to head public enterprises is obviously crucial. The Chairman is the person who is ultimately responsible for the industry, represents it in public, provides the qualities of leadership, forms the main channel of communication with Ministers, and appears before select committees. To do this effectively for a large complex industry means he must

be deeply immersed in the industry and therefore, it seems to the CPRS, must necessarily be a full-time appointment. But in smaller and simpler industries, where the demands of the Chairmanship are not so severe, there is much to be said for a part-time appointment.

48. In order to attract and retain a person of the necessary calibre it will be necessary not only to offer a suitable salary but also to assure him that Government will refrain from detailed interference.

49. A possible method of motivating Chairmen given clearly agreed objectives is payment partially by results, along the lines of the payments to Lazard Freres in respect of Mr MacGregor. This could also be useful presentationally when the Government is trying to restrict pay increases generally and tie them to increases in productivity.

50. Especially in situations where a Government wants radical change in an industry, it is important that although deeply knowledgeable about the industry the Chairman should not be captured by it. He must retain his objectivity, and not obstinately defend the industry against all change. He must be capable of appreciating the wider scene in dialogue with Government. Such a balance will be made easier if the Chairmanship is kept separate from the Chief Executive appointment in those industries where there is a substantial industry-wide executive job to be done. This will prevent the Chairman being swamped by detailed management issues. Equally it would help if the Chairman is an outsider, though given the size and complexity of the larger industries he would require some experience of the industry if he is not to be out of his depth. Most important of all, however, the danger of lack of balance would be averted if, before appointment, the Chairman is given a clear indication of the direction in which the Government wants the industry to move, in a set of clear objectives.

Leadership

51. In the course of our interviews many Chairmen pointed to the harmful effect that public criticism of the industries by the Government was having on the morale of staff. Clearly the nationalised industries have many defects, but they also have some good points. The CPRS believes that from time to time the good points could be highlighted and credit given where due; if done properly this could improve motivation across the public trading sector.

52. Another matter raised by Chairmen was frequent delay in making appointments or re-appointments at Board level. It was very unsettling and disruptive for the individual and the Board if re-appointments were left to the last minute. The CPRS did not investigate the circumstances surrounding individual cases, but it is obviously a principle of sound management to try to reduce uncertainty in the matter of appointments or re-appointments and to settle them as expeditiously as possible. This means that succession planning must be carried out well in advance, and the CPRS believes the non-executive directors have a role to play here.

Union Power

53. Enlightened leadership and close relations with Government are particularly important in those industries with problems of monopoly union power. It would be wrong for Government to interfere directly on these problems. This is largely a matter for the Boards and management of the industries. We believe that there is much scope in most of the industries for improvements in productivity and for tougher pay bargaining. But this must largely be achieved by skilled and determined efforts by the Boards and their management. And success probably depends upon steady progress over a number of years. In attempting these measures the Boards are likely to face considerable difficulties from their workforce, from their customers and from the media. The CPRS believes that the Boards will need the support and encouragement of Government if they are to strive successfully. And Government will wish to ensure that the Boards are trying hard. We believe that the sense of a businesslike partnership between Boards and Government will help considerably to create a better environment for tackling these problems and will stiffen the Boards' resolve. Putting it the other way round, a Board which feels that the Government does not understand its problems and continually denigrates it may not be strongly motivated to try. The damage that can be done by strong monopoly unions against timid management need not be recounted here.

H. GOVERNMENT

54. The relationship between Government and the nationalised industries is a multi-faceted one. We believe that it has at least six aspects:-

(i) The Government has to represent the interests of the public as shareholder - the 'owner' function;

(ii) The Government is also responsible in a broad sense for the interests of the public as customers of the industries;

(iii) The Government is banker to the industries;

(iv) It is also responsible, as Government, for the role of the industries in the economy;

(v) The Government has social objectives that impact on the industries, eg to retain a 'non-commercial' railway;

(vi) The Government is concerned with the role of the industries within wider policy objectives eg BGC within energy policy.

55. The third and fourth roles, banker and macro-economic interest, naturally and inevitably reside in the Treasury; the other roles reside largely, but not exclusively, in the sponsor Departments, who are also required to act as intermediaries between the industries and the Treasury. In drawing up clear objectives it will be necessary to comb through these different roles to ensure that each is adequately represented and potential conflicts are resolved.

56. Thus sponsor Departments are responsible for most aspects of the relationship between Government and the nationalised industries. They hold the key to improving it. We have to say that our discussions with Chairmen and others showed dissatisfaction with the performance of sponsor Departments beyond what might naturally be expected. It would be invidious to pick out detailed examples, but as a result of those discussions we are convinced that a radical improvement in their ability to supervise the industries is needed, in a number of respects:-

(i) more business expertise to understand in detail the commercial problems facing the industries and the business implications of political decisions;

(ii) more intensive effort to extract relevant information from the industries (including options when major policy issues are put forward, eg at IFRs);

(iii) more skilful monitoring of performance, so as to be able to give clear warnings to Ministers and the Treasury when there is a risk of an industry going off course;

(iv) better relations with the industries at all levels, including Chairmen and non-executive Board members, based on better understanding and clearer statements of objectives;

(v) stronger pressures for efficiency.

57. Sponsor Departments face a wide range of problems with their industries, and tackle their responsibilities in various ways. Officials are obviously well qualified to support Ministers on the more political aspects of their work but they are less well equipped on the more commercial aspects. Furthermore few Ministers have first hand experience of running very large industrial organisations. In our view the basic difficulty facing sponsor Departments is insufficient understanding of the industries as businesses. If there is to be proper understanding and communication between Government and the industries and if the arguments put forward by an industry are to be probed effectively, sponsor Departments must be able to equal the basic skills of the management. Without business experience in the sponsor Department, there is bound to be some lack of understanding, less than fully effective monitoring, unreal expectations and unnecessary shocks and disappointments. The Treasury finds difficulty in co-ordinating while information and effectiveness within Departments are so varied. When the Treasury's confidence in the effectiveness of a particular sponsor Department is undermined, it tries itself to fulfil the role without the knowledge, expertise and time. The result is that some industries are left wondering what role the sponsor Departments play.

58. We have started from the position that a fundamental institutional change is needed to achieve the necessary improvement in performance. Previous suggestions for making sponsor Departments more effective in their ownership function, while keeping their present organisation, have come to nothing.

Ministry of Nationalised Industries

59. The first and most radical option considered by the CPRS is a Ministry of Nationalised Industries. Nationalised industry policy would be concentrated within a single new Ministry while the Treasury fulfilled its traditional roles as banker and macro-economic guardian; other Departments would be concerned with sectoral or social objectives, and would negotiate these with the central Ministry. The concept has immediate attractions. It would concentrate the expertise to be found within the present sponsor Departments, and build on it so that the Ministry should quickly become an expert body. The Ministry could be granted an aggregate EFL by the Treasury for all nationalised industries, and could recommend for collective approval by Ministers an allocation of resources on the basis of its well-informed assessment of priorities. A single body should ensure consistency of approach. Moreover, it would allow Ministers of the present sponsor Departments to represent the interests of the private sector while a separate Minister argued the case for the public enterprises; these interests now have to be reconciled within each Department.

60. However, in the view of the CPRS the concept has drawbacks, which outweigh the advantages, at least in the short term. Perhaps most important for Ministers is the delay before it could come about and the upheaval required within Whitehall at just the time when the Government's MTFS is going through its most crucial phase. Effort would be diverted at the moment when control should be at its most effective. Furthermore the CPRS is convinced that until business experience is built up, it would be impossible to move to a Ministry of Nationalised Industries without a high probability of failure.

61. A Ministry of Nationalised Industries would indeed be a super Ministry, responsible for enterprises that generate around 10% of GDP and invest an amount annually of the same order as the whole of private sector manufacturing. It must be doubtful whether the Secretary of State heading up the Ministry could cope with the diversity of problems presented by all the state enterprises.

62. It may be that further examination could find ways of overcoming these problems, and that the Ministry of Nationalised Industries will prove to be the most effective long-term solution. However, given the constraints and the need for a quick solution, the CPRS did not pursue this option further. The CPRS proposal for introducing more business experience in the existing structure is consistent with, and indeed we would argue a necessary precursor to, moving to a Ministry of Nationalised Industries at a later date.

Expanded Treasury

63. Another possible solution is to integrate the ownership role within an expanded Treasury. The arguments on overall size and the prior need for business skills apply again. In particular, the possible overload on a single Minister responsible for the nationalised industries, referred to in discussing the Ministry of Nationalised Industries, would be even more serious for the Chancellor with his current heavy responsibilities. Even aside from these points, could the Treasury combine and reconcile the functions of owner, banker and overall responsibility for the industries in the economy? In the view of the CPRS this must be seriously doubted. There is a risk that undue weight would be given to short-term financial considerations, rather than commercial efficiency. There is also a risk that the interests of nationalised industries would not be effectively defended against the competing demands of other public expenditure programmes from spending Departments. The present system does at least mean that the nationalised industries have powerful spokesmen in Cabinet when their claims come to be balanced against those of other expenditure, such as social security, defence etc.

CPRS Proposal

64. We have concluded that the only solution that is practical in the short term is:-

(i) to modify the sponsor Departments and increase their business expertise so that they will be able to fulfil their role more effectively;

(ii) to establish a powerful Ministerial steering group for Nationalised Industries supported by a review staff with a business analytic orientation.

Modified Sponsor Departments

65. The proposal we favour is to set up, in each of the three major sponsoring Departments (Industry, Energy and Transport) a single separate sector of the Department - the Business Group - concerned with the industries as businesses, and exercising this function for the Department's portfolio of nationalised industries. The Business Group would be small but staffed with able people including some with business experience. The Business Group would undertake most of the Department's direct dealings with its nationalised industries.

Sectoral and other issues that did not exclusively affect the nationalised industries would be administered by officials in other parts of the Department; when such issues impinged on the nationalised industries these officials would of course consult the Business Group.

66. The advantage of separating the business from other interests is that it would allow the Business Group to develop expertise, and to gain understanding in depth of the industries, so that relations with the industries could develop on a more equal footing. With people who had a deep understanding of how an industry works it would be easier on any issue to form a judgement on how the proposal would affect its commercial interests, and to ensure that Government is explicit about, and calculates the cost of, pursuing non-commercial objectives. Once the different objectives had been resolved and balanced within Whitehall the Business Group would be the prime channel of communication with the industry. The nationalised industries would thus have to deal with a commercially-minded arm of Government which would support the Secretary of State by negotiating clear, tough, but realistic, targets with the industries. This should provide a good environment for the industries to improve their performance; moreover it would clarify accountability and remove the scope for excuses for failure.

67. An important feature of the Business Group is that it would deal with all the industries sponsored by a Department. This should promote a more consistent approach to the industries within the Department's portfolio, so that priorities between them could be set rationally. It should also help to prevent officials being captured by a single industry and accepting its views uncritically.

68. The main job of the Business Group would be to establish the necessary partnership with its industries. Its first task would be defining the objectives for the industry and getting them accepted. Thereafter its main emphasis would be on the Corporate Plan, which establishes the speed with which objectives are to be achieved, and financial targets. Non-commercial services undertaken at Government request would normally be identified and paid for. Performance indicators would be set and progress monitored. The relationship would vary somewhat for different industries, but these are the essentials. We do <u>not</u> envisage the Business Groups indulging in **'second-guessing'** of the industries' management, ie conducting elaborate studies to check management's own analysis. Rather we see the Business Groups knowing what <u>questions</u> to ask

the industries, judging whether the answers are adequate, and probing when they are not. This is the kind of role that a private sector holding company plays in relation to its subsidiaries. The role and staffing of the Business Groups is described in more detail in Annex C.

69. Many previous studies have identified the lack of expertise in Whitehall to fulfil such a role; there is very little direct business experience amongst civil servants. It seems to the CPRS that a necessary pre-requisite for breaking down the barriers towards a greater partnership is a greater understanding within Government of business. Opportunities certainly exist for achieving this :-

- more secondments to and from nationalised industries (as well as the private sector);
- more employment of people with business skills and experience, either on secondment or permanently;
- more training eg Business Schools with relevant courses on management, accounting, and other numerate skills;
- secondments between departmental Business Groups;
- secondments to the review staff of the Ministerial Committee.

70. A common long-standing complaint voiced by the industries is that people move too frequently within the sponsor Departments. In the industries' view it takes two to three years for someone in the sponsor Department to become properly informed on the industry and its problems, and this is comparable with the expected lifetime in the appointment. The industries themselves therefore waste undue time educating sponsor Departments. It is also said that personnel moves within sponsor Departments seem not to be co-ordinated. For instance, last year in the case of both BL and BSC there were almost simultaneous changes in the appointments at Deputy Secretary, Under-Secretary and Assistant Secretary level.

On coal, in the middle of the current complicated negotiations with NCB, there has been a simultaneous change at both Deputy Secretary and Under-Secretary levels. Such wholesale changes tend to undermine the relationship with Government in the eyes of the industries.

71. In order to enhance expertise within Whitehall, and to meet the points of criticism in the last paragraph, the CPRS would recommend that for civil servants in the Business Groups there would be a career structure that enabled them to spend much of their careers in dealing with the nationalised industries so that they built up the special expertise needed. They would generally stay longer in each post. Such people would be identified early and have their career path structured accordingly, including the development opportunities identified in paragraph 69. Their knowledge of business would be useful also to the rest of the Department in its dealings with the private sector.

72. The CPRS believes that the head of the Business Group, in particular for the larger Energy and Industry portfolios, should have wide business experience with the rank of Second Permanent Secretary, for the following reasons:-

(i) the Chairmen of the nationalised industries wish to talk on an equal footing and this requires someone of the highest standing in the business world, who could only be recruited to a very senior rank in the Civil Service;

(ii) the head of the Business Group would have the task of ensuring that the conflicts between commercial and political objectives, which cannot be entirely avoided, are resolved within Government on a proper understanding of the facts and arguments, rather than at the interface with the industries. To do this effectively he would need the standing we propose;

(iii) the head of the Business Group would have an influential role in finding non-executive directors of sufficient quality to serve on nationalised industry Boards; to do this effectively he would need to have sufficient status to talk informally with private sector Chairmen about particular individuals;

(iv) there is a danger that the Business Group would not become an effective force without strong and powerful leadership at the top;

(v) for Business Groups to offer attractive careers to able civil servants, it would need to be clear that this did not impair their chances of reaching a very senior level in the Civil Service.

73. It is envisaged that initially the Second Permanent Secretary would be an outsider, perhaps nearing the end of a successful career in business, as only such a candidate would have the experience and status we see as necessary. Clearly an outsider would have m u c h to learn about Ministerial and inter-departmental processes of decision-making; but we consider that for this post such experience is less essential than business expertise. However, as time goes on, with career structures more directed towards business, there would be an increasing likelihood that an internal candidate would be suitable. The Permanent Secretary would remain in overall charge of the Department's management and use of resources, and broader issues of sectoral policy.

74. The CPRS considers that these proposals for Business Groups are the minimum change needed if the Government is to be effective in its relations with nationalised industries. But we have to say that in our discussions with Ministers and senior officials in sponsor Departments, it has become clear that the Business Group concept does not commend itself to them. They argue that most of the problems with the nationalised industries are political rather than commercial and that there is value in the links between nationalised industry and sectoral work which Business Groups would lose. In particular it has been put to us that the presence of senior experienced businessmen in a sponsor Department would not be welcomed by the industries - Chairmen would not wish to be supervised by another businessman. Initially such feelings might arise for in some respects insufficient business experience in sponsor Departments gives industries an easy ride at present. But a suitable senior businessman in a sponsor Department should quickly be able to establish a good relationship based on mutual respect, and be able to remove the lack of understanding of their problems which the Chairmen now find frustrating. It has also been put to us that a senior businessman would impede the direct contact between Secretary of State and Chairmen (cf NEB's relations with BL and RR). But in our view there is little substance in this argument when the head of the Business Group (unlike NEB) would be reporting direct to the Secretary of State.

75. We believe that the other arguments could be met within the structure we envisage. We emphasise our conviction that there is no prospect of improving the relationship between the Government and the nationalised industries without a radical shift in the sponsor Departments towards a more commercially-minded approach. In our judgement this will not happen without changing the structure of the Departments, to mark the change in approach and put business expertise in a position to make a real difference. Merely to provide more business training or bring in a few people with business experience to form an advisory group would not be enough.

76. However, the CPRS must recognise that Ministers and senior officials in the sponsor Departments are in a strong position to judge what changes in management and organisation are needed, in the particular circumstances of their Departments, to implement this new approach. If after collective discussion our Business Group proposal still does not find favour, we suggest that each of the main sponsor Departments should be asked to review its organisation, taking account of our Business Group proposals, and to make its own proposals for securing the radical improvements in performance listed in paragraph 56 above, in a report to the Ministerial Committee (see below) within a specified time. Before leaving this section of our report we must emphasise that successful direction and supervision of businesses requires business knowledge. For very large complex industries the Chairmen, as mentioned elsewhere in this report, should be business executives of the highest quality. But comparable basic skill is needed within Government if they are effectively to be given the required broad strategic direction on a basis of mutual confidence. This is a problem of people not just/organisation. The improvements needed will not occur unless a few people of the right quality and experience play a leading role in sponsor Departments.

Ministerial Committee

77. The CPRS recognises that it is recommending a major cultural change, and to ensure that it takes place there needs to be some force in the centre, in addition to the Treasury, to guarantee that the Business Groups fulfil the role envisaged. There are also practical operating functions. For this purpose the CPRS recommends a small Ministerial committee. Because of the importance of the issues likely to arise and their impact on overall Government policy, the committee should be chaired by the Prime Minister, although to relieve the

pressure on her the Chancellor could sometimes deputise; in addition it would include Treasury and sponsor Ministers. The committee would become the normal Ministerial forum for collective discussion of the affairs of the nationalised industries. The following roles are envisaged for the committee:-

(i) if Ministers accept our main recommendations about setting clear objectives for the public enterprises, there is going to be a difficult process of transition. During this process the Ministerial committee needs to check that the objectives being developed for different industries are consistent with each other and with the Government's wider medium-term objectives;

(ii) the Ministerial committee would be the principal forum for sorting out priorities across the industries. It would also be responsible for ensuring that there was a consistent approach to the industries on such matters as investment appraisal;

(iii) the committee would also monitor the industries' overall performance against budget throughout the year. The Quarterly Monitoring Report currently discussed at E(NF) would form the basis for this. At the last E(NF) meeting it was agreed that the industries must be asked in advance for a quarterly breakdown of their expected performance for any given year. This will make monitoring much more effective, since it is only by comparing performance to date against budget that prospects for the year's outturn can be sensibly discussed. Together with our detailed proposals for monitoring in Annex D this should reduce the likelihood of surprises or shocks from the industries, although because of the sudden emergence of external factors it cannot eliminate them;

(iv) the committee would also consider questions of general industry policy:-

- privatisation, competition, liberalisation
- methods of financing
- pay
- prices (of the monopolies);

(v) the committee would also be available as a forum for discussion if Treasury and sponsor Department Ministers could not settle differences of opinion at a bilateral meeting.

It would be important that the committee should not become involved in those issues which ought to be settled by individual Departments and that, like Departments, it should resist the temptation to intervene in the affairs of industries on matters other than those of strategic importance.

Review Staff for Ministerial Committee

78. It follows from the nature of the functions suggested above that the Review Staff for the committee would need to have a probing, analytic, business-oriented role. It would ensure that Ministers address the right issues, are adequately forewarned of impending problems, and are supported with expert advice. It would be small and make recommendations on policy issues including priorities, and would carry out special studies. It would need to include people w i t h business experience. We favour locating it in the Cabinet Office rather than the Treasury. This would establish its neutrality between Treasury and Business Groups, so that the Business Groups should be more willing to co-operate with it and give it information than sponsor Departments are with the Treasury now. Equally it would not be subject to the same short-term public expenditure pressures that inevitably arise in the Treasury. One possibility might be for the Review Staff to be located initially within the CPRS while the new system is being set up. The Review Staff would exist only to service the Ministerial committee. It would restrict its attention to matters that were the proper concern of that committee; it would consciously avoid trying to beoome an additional layer in the machinery for controlling the nationalised industries.

79. The Review Staff would clearly need to work very closely with the Treasury, particularly on financial performance and investment review. In view of this the CPRS recommends that the secretaries for the committee should be provided jointly by the Review Staff and the Treasury.

Manpower Implications

80. The CPRS believes that the re-organisation into Business Groups and Review Staff can be brought about by redeployment without any overall increase in manpower except that there might be a small increase in the first few years as

business expertise is introduced into the Business Groups by secondments from outside. This is discussed in more detail in Annex C. But the CPRS cannot comment in detail on individual Departments. If Ministers accept the CPRS recommendations it will be the responsibility of individual Departments to advise how the principles could be applied in specific instances.

Treasury

81. The above proposals will leave the Treasury role unchanged in theory but different in practice. The CPRS believes that the Treasury divisions dealing with nationalised industries are at present significantly overworked. From what Treasury officials have told us it seems that this results partly from lack of expertise in some parts of the sponsor Departments; this should be rectified by our proposal for Business Groups and the Review Staff serving the Ministerial committee.

I. MINIMUM REQUIREMENT FOR CHANGE

82. The CPRS proposals, in particular on clearer objectives and more expertise within Whitehall, are aimed at making the present system work effectively, not a major reform. Because of this, the proposals should be capable of implementation without statutory changes. But at some stage there could be a need for legislation, if some of the industries resist necessary changes which are in line with the Government's objectives, or refuse to provide information. However, the CPRS believes that it will be a sign of the success of the new arrangements if such problems can be overcome by persuasion rather than legislation. It may also be necessary to legislate for changes in nationalised industry Board size and structure in a limited number of cases. Our recommendations for institutional change within Whitehall do not involve changing the established relationship of the industries with either sponsor Ministers or Parliament.

83. Re-organisations are necessary to make people behave differently, but they are not sufficient in themselves. In order to change behaviour there has to be a change in pressures. Implementation will need a push by Ministers and a willingness to accept change by the sponsor Departments. What then are the minimum mutually supporting requirements in order to achieve the improved relationships we are seeking? In the view of the CPRS these are fivefold:-

(i) clear objectives must be set for each industry;

(ii) the sponsor Departments must become more business oriented; our preference is for Business Groups headed by senior experienced businessmen with the rank of Second Permanent Secretary;

(iii) the Ministerial committee, as well as dealing with policy issues, must review progress on implementing the change and must closely monitor progress to ensure that each party is fulfilling its new role;

(iv) within the industries the Chairmen must be of the right calibre, and must fully accept the objectives;

(v) the non-executive directors must be of high quality and be given precise tasks to fulfil.

J. Summary of Recommendations

84. The full list of our recommendations appears below; the numbers in brackets indicate the paragraphs where the recommendations appear in the report :

1. Government to set clear objectives (20-24) to be quantified through the Corporate Plan and annual budget (25-27).

2. Government to monitor performance against objectives employing an improved information system (29-30) similar to those used by large private sector companies.

3. Boards of the more 'monolithic' industries to try, as far as sensible, to break up the structure into smaller profit centres (31).

4. Reorganisation of the Electricity Supply Industry to be considered (32).

5. Boards to be restructured so as to be smaller (37) and to contain a majority of non-executive directors (33) but, in normal cases, not including civil servants (39).

6. Responsibilities of non-executive directors to be set out by the Secretary of State (34) and to include the operation of an Efficiency Audit Committee (36) and advising on Board appointments and salaries (34).

7. A few senior executive positions in certain industries to be filled if possible by outside appointment (40).

8. Executive directors to be encouraged to take non-executive directorships in the private sector (40).

9. Industries not fully exposed to competition to be subject to regular external efficiency audits (41),

to be carried out for the time being by the MMC and management consultants (44), with an emphasis on proposals for implementation (41 and 44) on which the Efficiency Audit Committee of the Board can check that appropriate executive action is taken (45).

10. In the longer term, particularly if Ministers decide to explore the possibilities for independent regulation, the arrangements for efficiency auditing to be subjected to a fundamental review (43).

11. The Chairman of the Board, where possible, to be separate from the chief executive (50), and, in some of the smaller and simpler industries, to be a part-time appointment (47).

12. The Secretary of State to obtain acceptance from the Chairman, before appointment, of the strategic objectives for the industry (50) but to refrain from detailed interference (48); the possibility of linking Chairman's pay to the performance of the industry to be considered (49).

13. Government to encourage Boards by praising good performance (51) and by planning appointments and re-appointments earlier (52), and to support the Boards closely in their efforts to deal with problems of union power (53).

14. Each of the main sponsor Departments to set up a Business Group (65-68), to be staffed by officials with a more specialised career progression (71) plus a few secondments from the business world (69), such staff to spend longer in each post than at present (70) and to be led by a second Permanent Secretary (72) who, in the first instance, would be a senior and respected businessman (73); the precise form of the Business Group to be designed by each sponsor Department in the light of its particular requirements.

15. If recommendation 14 does not find favour with Ministers collectively, then each of the main sponsor Departments to be asked to review its internal organisation for supervising its industries and to report back to the Ministerial Committee within a specified time with firm proposals (76); this review to consider effective means for bringing more business expertise into the Department's dealings with industries, for establishing clearer objectives, for better analysis of strategic options, for more skilful monitoring of performance and for exerting stronger pressure for efficiency (56); the review to take account of the CPRS suggestions about Business Groups.

16. A Ministerial Committee to be formed to oversee policy for Nationalised Industries (77).

17. The Committee to be supported by a small Review Staff with business expertise based in the Cabinet Office (78) and the secretaries to be provided jointly by the Review Staff and the Treasury (79).

ANNEX A

OBJECTIVES FOR NATIONALISED INDUSTRIES

As explained in paragraphs 20 to 29 of the main paper the CPRS believes that a satisfactory relationship between Government and Nationalised Industries can only be achieved if clear objectives are set out for the latter and agreed by both parties. As an indication of the types of objective we have in mind we list below a purely illustrative set of possible objectives for British Telecom (BT). We have selected BT because:-

- it has, till now, been a monopoly and so provides an illustration of the need for the objectives of monopoly industries to compensate for the lack of market forces;

- it is an industry which the CPRS has studied recently;

- it provides an illustration of some of the issues that arise when steps are taken to introduce competition and to privatise some or all of an industry.

2. We recognise that the setting of clear objectives raises difficult issues; indeed one of the main reasons for establishing such objectives is to get these issues resolved. We wish to stress that in offering the list below we are in no way claiming to have solved the difficult issues arising in the case of BT but merely to illustrate the general types of objective that could apply.

3. The Secretary of State might consider setting BT the following objectives:-

(i) to provide telecommunications services to meet the demands of existing customers, consistently with statutory obligations, and those of new customers;

(ii) to achieve a financial target (rate of return on assets) and to operate within borrowing limits set by the Secretary of State, and approved by the Treasury;

(iii) to improve operating efficiency in accordance with indicators of performance and quality of servie to be agreed with the Secretary of State;

(iv) to negotiate pay settlements at lowest levels consistent with adequate recruitment and other relevant factors, particularly productivity improvement;

(v) to set tariffs in accordance with guidelines agreed with the Secretary of State;

(vi) to plan a programme of investment within guidance from the Secretary of State as to both the shape and the overall size of the programme, with projects to be appraised using government-approved techniques, and the Secretary of State to be consulted on any project above a stated size;

(vii) to operate procurement policies along lines to be agreed with the Secretary of State with due regard to the long term interests of UK suppliers and in particular their international competitiveness.

The Secretary of State might also wish to set objectives in relation to privatisation and competition such as :-

(viii) to organise BT into separate profit centres, as far as this is sensible, and in collaboration with Department of Industry to set up subsidiary operating companies as candidates for privatisation or for joint ventures with the private sector;

(ix) to make progressive arrangements, jointly with the Secretary of State, so that control of BT can pass to the private sector;

(x) not to stifle new competition, eg to refrain from unreasonable anti-competitive behaviour, such as predatory pricing and abuse of regulatory powers.

4. Clearly some of these objectives interact with others and in some cases may conflict with them. In order to get a tight grip on, say, the borrowing requirement Government will need to set the other objectives accordingly. It will also need to ensure that the implications are followed through in BT's Corporate Plan and annual budgets so as to be confident that BT is set on a course that will not breach the borrowing limit.

5. To some extent BT already operates according to objectives of the kind listed in paragraph 3, as do the other monopolies. But for none of them have we found objectives clearly and concisely expressed in a single document. In some cases informal understandings exist but these are likely to conceal uncertainty in the Government's mind, or a difference of view between Government and the industry. We consider below the extent to which clear objectives are currently set for BT, the difficulties that are encountered, and the extent to which further definition of objectives is required. From our knowledge of other monopolies we suspect that similar difficulties are encountered with them.

Objective (i): Servicing Demand

This objective will need elaboration. If Government believes that certain demands should take priority over others this should be stated, eg whether leasing private circuits to business users should take precedence over increasing the number of circuits available to subscribers on the public network.

Objective (ii): Financial Target and Borrowing Limit

A financial target for 1981-82 was never set formally although one was implied when last year's Public Expenditure White Paper was published. Department of Industry officials have argued with BT that the Government clearly intended that the target should have been 6½%. BT have not accepted this. Their position is that the target was 5%, as agreed in earlier years, and they have continued to plan on that basis. With regard to borrowing the Government has stated its position clearly. BT must live within its External Financing Limit (EFL), like all nationalised industries.

In April BT was set a (revised) EFL for 1981-82 of £380M. BT on the other hand have proposed an External Funding Requirement (EFR) of £500M in their latest Medium Term Plan; this remains their formal bid for funding in the current year and provides the basis of their planning. BT say that this funding is needed to permit them to carry out an investment programme which they believe they can justify on economic grounds; they also argue that they should be permitted to raise the extra £120M by borrowing from the private sector. At the present time, in the middle of the year in question, the difference between BT and Government has still not been resolved.

Objective (iii): Efficiency

In 1978 a performance indicator ('real unit cost') was agreed and targets for improvement were set. Recently BT's performance, as measured by the indicator, has declined, partly as a result of the recession. BT now argue that the design of the indicator was defective, in that it reflects events which are beyond their control, discourages investment and that, paradoxically, shedding manpower does not influence the indicator. The Department of Industry and the Treasury accept these arguments and are working with BT to design a new indicator. However it is hardly satisfactory that the defects of an indicator become evident only when performance appears to deteriorate. And it may be that the apparently good performance in the earlier years of the indicator's brief lifetime was as spurious as the apparently bad performance more recently. Another criticism is that a cost indicator, on its own, is insufficient. Costs can always be cut by reducing standards of service. A set of indicators is required which measures both costs and service standards.

Objective (iv): Pay

The 1980 Medium Term Plan did not express clearly BT's assumption about pay increases for 1980-81. We have been told that BT's intentions were not clarified in the Investment and Finance Review that followed. During the year BT negotiated a settlement with the POEU which included an 18% rise in basic rates and a 3% addition for productivity. As a result of this and other agreements, average earnings increased by 26% for the fiscal year 1980-81 relative to 1979-80. Clearly this was generous in relation to Government expectations for public sector pay. Since then Treasury officials have proposed a restriction in BT's EFL for 1982-83 to claw back some of the generosity of the 1980-81 settlement. This is an unrealistic remedy. We consider that this episode illustrates the need for the sponsor Department and the industry to assess jointly the likely outcome of pay negotiations before they start.

Objective (v): Tariffs

There has been disagreement about tariff policy. During this year's IFR Treasury officials argued for exploiting the monopoly by increasing tariffs in order to minimise the PSBR. BT, on the other hand, argued for lower tariffs on the grounds that present customers should not have to fund the investment programme;

BT believe that their investment should be supported by an element of borrowing. The Department of Industry argues that BT should be allowed freedom to bring tariffs steadily into line with the levels that will prevail when the market is opened up to competition. Because of the lack of a clear policy for tariffs Government was not able to give guidance to BT in its preparation of the Medium Term Plan, and the subsequent discussion of this key aspect of the Plan was inconclusive.

Objective (vi): Investment

We were struck by an inconsistency in the way Government appraises BT's investment. Although the investment programme for each year is subject to an overall appraisal, individual projects, spread over a number of years, are not. Most notably the System X project, which represents one of the largest investment projects ever carried out in the UK, has never been subjected to formal Government appraisal and endorsement.

Objective (vii): Procurement

BT in common with the PTTs of other major industrialised countries has a policy of purchasing almost entirely from domestic suppliers and this policy has had the support of successive administrations. But straightforward protection is not necessarily in the best long-term interests of UK suppliers since they may then become overly dependent upon a h o m e market and unable (or unwilling) to compete aggressively in export markets. The supplying industry should be encouraged to look first to export markets. BT's technical specifications and procurement programmes should be designed to support and reinforce export marketing rather than to prop up a fragmented and inward looking industry. The Government has a role in stimulating innovation and export efforts by the industry and in encouraging BT to buy British, even at some cost penalty provided that these wider aims are pursued. As an alternative BT could be allowed more freedom to purchase its equipment from abroad, on world competitive terms.

ANNEX B

BOARD SIZE AND STRUCTURE

1. This annex gives information on the present size and structure of a selection of nationalised industry boards. It also comments further on the question of improving the size and structure of boards and the experience and qualities of non-executive directors.

2. The chosen sample of industries from the transport, manufacturing and energy sectors is shown in the accompanying table. A major exclusion is that of the Post Office where the precise appointments to the proposed separate boards for Posts and BT have yet to be decided and/or announced. The numerous regional electricity boards have also been omitted to keep the table to a manageable size. It is felt nevertheless that the eleven boards covered give a reasonable cross-section against which to draw general conclusions.

Board Size

3. The CPRS considers that a board comprising 7 - 10 members including the chairman is to be preferred in most circumstances. A board of this size is large enough to meet the needs for expertise and representation at board level and small enough to ensure cohesion and effective decision-making.

4. For the majority of industries shown, it would be possible to accommodate this recommendation without statutory change but some reduction in the present size of boards would be involved. Excluding the Electricity Council, which is in an exceptional position, the selected boards comprise, on average, 13 members, including chairman, compared with an average statutory minimum of 8. BA, BS, BSC, BR and BGC stand out as being particularly large boards well above their statutory minima.

Board Structure

5. On structure, the main CPRS recommendations relate to the number and quality of non-executive directors though, in passing, we note that the majority of chairmen of boards shown in the table are full-time and, moreover, are supported by full-time deputies or chief executives.

6. The table follows the convention of dividing members (including deputy chairmen but excluding the chairman himself) into full- and part-time; for the most part, this division corresponds to the distinction between executive and non-executive directors. (Exceptions occur in the NCB and BGC where some

part-time members are on the executive pay-roll.) No particular pattern emerges: non-executive directors are in the majority in over half of the boards shown in the table. Of important boards not covered there, non-executive directors are in the majority on the BL board but not on the Rolls Royce or the present Post Office boards. The background of non-executive directors is diverse - present incumbents include industrialists, trade unionists, civil servants and academics - and varies considerably, both between and within boards. Thus there is no guarantee that existing non-executive directors, even where they are in the majority, will operate in an effective business-like fashion.

Non-Executive Directors

7. Our discussions with Chairmen and Sponsor Ministers and officials have convinced us that quite a number of present non-executive directors are not suited to the tasks which we envisage for them, notably the pursuit of efficiency; indeed in several instances they play a very passive role. We therefore suggest that sponsor Departments review the qualities of the present non-executive directors of each industry and prepare plans for selecting new ones where necessary. This process will take time but the aim should be to have a complement of non-executive directors with the right experience and attitudes as soon as possible. To this end it may be necessary to supplement natural wastage by persuading some directors to leave early.

8. We also recommend that those present non-executive directors who are of the right calibre be encouraged to adopt the new roles we propose for them. This means that sponsor Departments will have to spell out what is wanted. We suggest that sponsor Departments should act as quickly as possible on this and on our suggestions for reducing board size and appointing a majority of non-executive directors with private sector experience.

BOARD STRUCTURE OF SELECTED NATIONALISED INDUSTRIES

BOARD	STATUTORY COMPLEMENT		PRESENT STRUCTURE			
	CHAIRMAN PLUS :		SIZE EXCLUDING CHAIRMAN			
	Minimum	Maximum	All Posts	Full-time Posts	Part-time Posts	SPECIAL FEATURES
BRITISH AIRPORTS AUTHORITY	5	9	7	3	4	Chairman is full-time; Managing director post separate from Chairman's post; deputy chairman is part-time.
BRITISH AIRWAYS	7	14	14	6	8	Chairman is part-time; Deputy chairman and chief executive combined full-time post; also a part-time deputy chairman.
CIVIL AVIATION AUTHORITY	5	11	11[1]	4[1]	7	Chairman is part-time; 3 part-time members work at least 3 days a week on average. Deputy Chairman is full-time.
BRITISH SHIPBUILDERS	7	20	14[2]	5	9[2]	Chairman and deputy chairman are full-time
BRITISH STEEL CORPORATION	7	20	16	3	13	Chairman is full-time; Full-time deputy chairman/chief executive. Part-time members include 2 civil servants and 6 trade unionists.
BRITISH RAIL	9	15	14	7	7	Chairman is full-time; 1 deputy chairman full-time; 1 chief executive full-time; 2 full-time vice chairmen.
NATIONAL BUS COMPANY	5	10	10	4	6	Chairman is part-time; 1 full-time chief-executive/ deputy chairman.
NATIONAL COAL BOARD	8	14	11[3]	6[3]	5	Chairman is full-time; Statutes specify a maximum of 8 full-time members. There is a full-time deputy chairman. 1 part-time member paid as an executive of the NCB.
BRITISH GAS CORPORATION	10	20	15	6	9	Chairman is full-time; Full-time deputy chairman; 3 part-time members paid as executives of BGC.
ELECTRICITY COUNCIL	2	5	4	4	0	Chairman is full-time; Full-time deputy chairman; part-time deputy chairman post vacant.
CENTRAL ELECTRICITY GENERATING BOARD	7	9	7	4	3	Chairman and deputy chairman are full-time.

All figures based on returns from Departments received by 13 July 1981

Notes 1) Number of full-time posts shown includes member to be appointed on 1 September 1981
2) Figures exclude 1 part-time member whose appointment expires on 30 July 1981
3) Figures exclude one full-time member whose appointment expired on 14 July 1981. His successor has yet to be appointed.

ANNEX C

THE ROLE AND STAFFING OF BUSINESS GROUPS

1. Present sponsor Departments perform a wide variety of functions in relation to nationalised industries. In general terms, the departments face in two directions, as advocates within Whitehall for the industries for which they are responsible and as agents of the Government towards their industries. More particularly, Departmental functions include advising the Secretary of State on policy issues affecting the industries, ensuring that wider industrial, sectoral and national interests are taken into account by the Boards; safeguarding the investment of public funds; responding to Parliamentary Questions and dealing with Ministers' case-work; advising on legal questions and administering the statutes. The amount and nature of work required, as well as the emphasis on dealing with the nationalised industries as businesses, varies enormously between divisions and Departments. This is reflected in the widely differing numbers of sponsor officials dealing with different industries which are shown in the table at the end of this Annex. (We would stress that the numbers in this table represent very approximate estimates from Departments; they are however valid for illustrating the great variation in present numbers.)

2. As explained in paragraphs 20-28 of the main report, the CPRS believes that greater weight should be placed generally on the strategic business direction of the nationalised industries and that detailed intervention should be avoided. To this end, we propose that each of the main sponsor Departments - Industry, Energy and Transport - be reorganised internally so that a distinct Business Group can concentrate on strategic direction of the nationalised industries for which the Department is responsible, as described in paragraphs 65 to 73 of the main report.

3. This annex explains in more detail :

- the role of the Business Group in relation to the industries
- the staffing implications
- the considerations that should determine the division of responsibilities between the Business Group and the rest of the Department.

The Role of the Business Group

4. We envisage a Business Group administering Government's dealings with the industries sponsored by its Department, including :

(i) setting objectives

(ii) agreeing medium and short term targets via a Corporate Plan and an annual budget

(iii) monitoring performance and ensuring that remedial action is taken when performance deviates from targets

(iv) acting as Government's point of contact for political matters affecting the industry, assessing their commercial implications and explaining these to the rest of the Department and the Treasury.

5. Our proposals for objective setting and monitoring are described in Annexes A and D respectively. Here we describe what the work of the Business Group might be once the objectives have been set and the monitoring system set up. In order to indicate some of the more commercial aspects of the work we list below some tasks that might arise in the case of a monopoly utility; industries in a competitive situation would usually require less detailed supervision.

Revenue :

- Check macroeconomic and market assumptions; ensure that demand forecasts have been examined against alternative assumptions.
- Examine tariff policy against estimates, where appropriate, of long run marginal costs and in relation to business priorities.
- Check technical basis of price elasticity assumptions.
- Ask industry after discussion to estimate overall revenue effects of alternative tariff packages and alternative demand projections.

Costs and Efficiency :

- Negotiate a set of indicators of performance and service to customers.
- Monitor performance against the indicators and understand the reasons for variances when things go wrong.
- Ensure that external efficiency audits are carried out according to a pre-set programme.
- Check that the Board's Efficiency Audit Committee is functioning effectively.

Pay and Productivity :

- Discuss with the Board and senior management their industrial relations policies particularly in those industries where unions are exploiting monopoly power; liaise with management in their efforts to secure reasonable pay settlements and productivity improvements.
- In cases where there is a risk of an industrial dispute, establish a position that the Government and the Board will agree to support.

Capacity :

- Check required size of system/amount of plant in relation to projected demand.
- Check reasonableness of assumptions about utilisation.

Investment :

- Check that major projects have been properly appraised; examine key assumptions and check that appropriate sensitivity analysis has been carried out.
- Examine how investment proposals fit into business objectives.
- Extract a project implementation plan with annual targets and budgets; monitor subsequent progress; scrutinise overruns above a certain size.

Financial Monitoring :

- Monitor financial performance monthly/ quarterly against targets.
- Examine deviations from targets, and discover reasons and establish what action is being taken.
- Review at quarterly or monthly intervals projections for the year and likelihood of achieving annual targets especially the EFL.
- (Other monitoring is considered in Annex D).

6. In carrying out the more analytical tasks in this (purely illustrative) list the emphasis would be on the Business Group checking that the industry had itself carried out the appropriate analysis rather than the Business Group carrying out its own independent analysis, although this might sometimes be necessary. It would not be the task of the Business Group to 'second-guess' the industry but rather to ensure that industry was making a competent first guess. To carry out this function the Business Group staff would need to have the ability to know what questions to ask and to identify and probe inadequate answers. It follows that the staff would need to have business expertise, technical and numerate skills, and also a sufficient understanding of each industry. The implications for staffing are described in paragraphs 8-13 below.

7. The failings of the present system are very apparent in the Investment and Financing Reviews (IFR). The IFR ought to be the centrepiece of the relations between Government and each industry, where the latter's Corporate Plan is discussed in detail, assumptions probed, options displayed and a firm basis for financing decisions established. And yet many participants, past and present, from Government and from the industries, have told us that the Review process is ineffective; and our own knowledge of the conduct of some of the Reviews confirms this impression. When the industry produces a Corporate Plan it typically represents a set of Board decisions, rather than options for consideration. In the short time of the Review much time is spent by Government officials trying to understand the plan, to establish agreed conventions (eg for inflation adjustments) and to obtain further information. Even when, eventually, the content of the plan is examined the discussion sometimes appears to be more about winning debating points than about negotiating substantive changes.

Staffing

8. The selection of the right man to head the Business Group will be of crucial importance. The success of the change within the Department will depend on him. He will need the skill to supervise and lead by persuasion the nationalised industries for which he is responsible; men of the calibre required as Chairmen must not feel he is infringing their proper authority. He will have to convince them that because he understands business matters he cannot be hoodwinked by them and that the same talents will enable him to put their case knowledgeably and fully within the Department. On the other hand, he will need quickly to work alongside the rest of the Department in order to play a major role in reconciling the unavoidable conflicts between business

and political aims that at present occur disruptively at the interface with the industries. It will be his task to "sell" to the industries the compromises that from time to time are necessary.

9. A suitable candidate is likely to be one who has had experience in a large c o m p a n y of directing the affairs of subsidiaries by persuasion rather than by command, and through leaving detailed management in the hands of the executives of the subsidiary.

10. Turning now to the staffing of the rest of the Business Group we suggest that officials for this work be identified early in their civil service careers. Their career progression should then be designed to give them the necessary expertise and experience for the work. Some features that might be included are :-

- training (eg at a Business School);
- early secondment to a job in nationalised industries or private sector (the secondment of a Principal from Department of Industry to act as Personal Assistant to the Chairman of British Leyland is one example);
- alternatives for later secondments might be to (and from):
  - Nationalised Industries and private sector firms
  - Business Groups in other sponsor Departments
  - Efficiency Audit body such as the MMC
  - The Review Staff of the Ministerial Committee for Nationalised Industries
  - Treasury
- different jobs in same Business Group, but staying at least 4 years in each.

11. Their career should not however be limited solely to nationalised industry affairs. They might also do a job outside the Business Group to give them a wider view and experience of their Department's work. With this flexibility and the high standing of the head of the Business Group, it should be possible to design careers with expectations at least as good as those elsewhere in the civil service.

12. The Business Groups would employ numerate specialists (accountants, economists, engineers, scientists) as appropriate. We would expect that they would, in general, have the same opportunity to progress up the Business Group career structure as officials of more generalist origins; we do not see them employed simply as 'back-room' specialist advisers.

13. We see no reason why the total number of staff in a sponsor Department, reorganised in the way we propose, should need to be any greater than at present. Eventually it may even be possible to reduce staff numbers since Business Groups, with their greater expertise and experience, should be able to discharge their responsibilities more speedily than would be expected at present. However during the transition phase we suggest that a small number of staff with business experience would need to be seconded into the Business Group, on a temporary basis, from the private sector (or from the nationalised industries themselves) in order to establish the new culture, and we recognise that this might lead to a temporary increase in staff numbers. However once the new culture was firmly established staffing could revert to current levels, or lower; whilst there would still be value in continuing with a number of temporary secondments from the business world this could be offset by reducing the number of permanent officials.

Division of Responsibilities Within Sponsor Departments

14. Under our proposals the Business Group would discharge under the direction of the Secretary of State his responsibilities in relation to the industries. However the Secretary of State has wider responsibilities, notably for sectoral and regulatory issues, which although they may impinge upon the nationalised industries also impinge upon private companies operating in the same sector of the economy. We envisage that responsibilities such as these would be discharged by officials outside the Business Group, but working closely with those inside.

15. The precise division of duties will depend upon the nature of the work in each sponsor Department and can only be settled there.

APPROXIMATE NUMBERS EMPLOYED IN SPONSOR DEPARTMENTS ON NATIONALISED INDUSTRY WORK

ENERGY	COAL	GAS[1]	ELECTRICITY[2]	BNOC
	35	37	51	11

INDUSTRY[3]	CABLE & WIRELESS	POSTS	BT	BSC	BS	BL	RR
	3	7	18	10	9	9	6

TRANSPORT	BR[4]	BTDB[5]	NBC[5]	NFC[5]
	55	10	8	6

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1) Excludes gas standards branch
2) Excludes 33 posts for Electricity Meter Examination Service
3) Industry figures exclude clerical officers and assistants
4) Excludes 21 posts in the Railways Inspectorate
5) Figures include some staff whose time is only partly spent on these industries

ANNEX D

MONITORING NATIONALISED INDUSTRIES

The evaluation of plans and monitoring of performance

Introduction

1. During the course of the study, CPRS has, together with Hacker Young, Chartered Accountants, as consultants, looked in detail at the cycle of planning and monitoring of four nationalised industries, and has briefly compared the methods with those used by a small sample of private sector holding companies. The four industries chosen were BL Limited, British Steel Corporation, British Rail and the Central Electricity Generating Board.

2. We found that although the assessment of corporate plans and monitoring of performance of some of the selected industries are comprehensive and effective in other cases they are inadequate. For example, in the case of BL, officials are closely involved and generally well informed. In the case of CEGB, however, officials have an "arms length" relationship with the electricity supply industry, and are hampered by its structure, which places the Electricity Council between the Generating Board and the Government, without power to control it.

3. A full report of our study is being prepared separately; this Annex describes the main conclusions and recommendations.

Purpose of Monitoring

4. Monitoring essentially consists of comparing actual results against expectations, assessing the reasons for any divergence and coming to a view on the need for corrective action.

5. A good monitoring system should provide a sponsor Department with up-to-date knowledge of what is happening in an industry. The regular flow of information makes the Department less dependent on the answers which the industry is prepared to give to ad hoc questions. This should increase the Department's ability to anticipate problems before they occur. The build-up of knowledge should make the Department better able to understand and assess strategic options. The industry itself is likely to take more trouble if it knows that its returns are being monitored and any deviation from forecasts will need to be explained.

6. From the viewpoint of the industries, direct contact with some of them has confirmed that effective professional monitoring by Government would give the industries the following benefits:

(i) An objective appraisal of their strategies and performance.

(ii) An increase in the value of their discussions with Ministers who will be better informed and more up-to-date.

(iii) Greater assurance that Government fully understands their needs when negotiating on their behalf in international or other forums, for example, in obtaining EEC approval of BSC's Corporate Plan.

What should be evaluated and monitored?

7. To be effective, monitoring must be comprehensive. There should be a logical flow from discussion and agreement of the Corporate Plan and the development of the one-year Budget through the regular monthly reporting of results to the use that is made of the information within Government. The intelligent reading of results should be followed up by searching questions to the industries to make sure that they too have spotted potential problems, are taking action and the action is having the right effect. The information should flow onward as necessary, and in an appropriate form, to Sponsor Ministers, Treasury Ministers and all Ministers collectively, both on a regular basis and as "exception reports" when things go wrong.

8. Parts of the existing system come closer than others to the procedures we would recommend. But the main changes to current practices entail a much closer involvement on the part of officials in the assessment of the Corporate Plan, the provision of a phased Budget, monthly reporting and meetings, the monitoring of major capital projects in progress, and improvements in the system of routine reporting to Ministers. The main elements are described in more detail below.

(a) The Corporate Plan

9. The Corporate Plan should be a comprehensive medium to long term forward plan; it should cover, for example, a 3-7 year rolling forecast (depending on the lead times, certainty of forecasting market demand etc. for each industry) and describe the options, assumptions and risks, and chosen strategy for the industry. It should cover sales, manpower, profit and loss account, balance sheet, source and application of funds, cash flow, financial targets,

performance indicators and capital investment, for the industry as a whole and broken down by product Group or Division.

10. At present, the Corporate Plan is not always sufficiently detailed and does not describe alternative options available to and considered by the industry. Ministers may only be presented with one final strategy on a "take it or leave it" basis. For example, BL Limited's 1981 Corporate Plan essentially offered no serious alternative to the injection of £990 m by the end of 1982/83. BR's Plan was intended for its unions as well as the Department of Transport and as a result it lacked detail and was somewhat political.

11. Good monitoring can in turn increase the ability of Sponsor Departments and where appropriate, the Treasury, to evaluate Corporate Plans and other longer term forward strategies. For example we were told that close monitoring of BL Limited's current progress indicated that this year's Corporate Plan may contain unnecessarily large contingencies for capital expenditure. Capital projects will therefore be examined particularly carefully when the next Plan is submitted.

(b) Annual Budget

12. Once the Corporate Plan has been agreed, this will automatically establish the objectives to be monitored. A one year detailed Budget (including the forecast of cash flow and capital spending) should be made up for Year 1, phased to show month-by-month progress. The Budget summary should be directly comparable with the proposals in the Corporate Plan.

13. At present, it is often difficult to assess the significance of results in any one period because forecasts are not always phased to take proper account of expected fluctuations in activity over the course of a year. This problem has recently been discussed at E(NF), where Ministers agreed that industries should provide a breakdown of forecasts, showing how they expect to move towards their targets as the year progresses.

(c) Monthly Report

14. The monthly results, including all the main financial figures (profit and loss, cash flow etc.) should be presented in the same format as the Budget and Corporate Plan. The degree of detail should be decided by the sponsor Department in the light of the particular industry's nature and circumstances. The report

should show the latest level of key factors that formed the underlying assumptions behind the Corporate Plan (exchange rates, market share etc), with if necessary a note about the effects if an assumption proves markedly wrong. Where relevant updated cash forecasts for the next 3-6 months on a month by month basis should be provided.

15. Each quarter the monthly report should be supplemented by a further statement covering other features as set out in the Budget, including progress on appropriate performance indicators.

16. In the reports the results for the month, year to date and latest expected outturn for the year should be compared with the agreed forecasts:

(i) Operating results against Budget and last year actuals;

(ii) Actual capital expenditure against the capital budget;

(iii) Actual cash flow and EFL against the original cash forecast.

17. Where there is a substantial difference between the results and Budget, an explanation should be provided.

18. At present, the minimum periodic reports required by Government from each industry consist of a Monthly Funds Flow Statement and an exceedingly brief Quarterly Profit and Loss Statement. With the exception of some industries, e.g. BL Limited and BSC, which issue detailed and comprehensive monthly progress reports, the level of information provided by the industries, even when supplemented above the minimum requirement, is insufficient to give a comprehensive picture of their progress and difficulties.

19. The presentation of results in some of the reports is not sufficiently clear because the layout is difficult to follow. Comparison of the current figures with the budget or the previous year's results may not be easy to make. Not enough information is given about the trend of financial results and other performance indicators, except in the case of BSC whose monthly reports include graphs of trend lines. These enable the industry's progress over time to be more readily appreciated. An informative written commentary describing the reasons why certain actions have been taken should also be given.

(d) Capital Projects

20. Where capital projects are large enough to require approval by the Secretary of State, officials should be involved in the appraisal of these projects, and should

monitor their progress. It would not be appropriate for them to carry out independent post-project audits, but they should ensure that the industry does so, and should see copies of the audit reports.

21. We assume that reports on the progress of capital projects are available within an industry, but several industries (e.g. BSC) do not supply them to the Sponsor Department even for the largest projects. DEn has recently arranged to receive monitoring reports for the CEGB Heysham II project, but they are not very informative. DEn hopes gradually to extend the arrangement to other major projects, but the bulk of the investment programme will not be covered for some time.

Procedure

22. It is essential that returns should be punctual, complete and accurate. E(NF)(81) 3 reported that only five industries out of eighteen had met the four week deadline for the Quarterly Monitoring Report to E(NF). Of the remainder another five had not even provided a single-figure estimate of outturn. This tardiness contrasts with the discipline in the private sector, where Head Office would normally insist that financial information be submitted on time.

23. The Treasury said that several industries tend to omit information from the monthly and quarterly returns when prospects become uncertain. This is just when it is most important for the returns to be complete. A recent example has been that the Treasury over a period of 6 months was unable to obtain figures outlining prospects for the coming year from BR.

24. It is suspected that some of the figures supplied in a number of returns have been inaccurate. For example, in certain cases the estimates for the outturn for the year were not updated to take account of later events. Also the omission of "extraordinary items" from the quarterly return means that the profit figure shown may be unreliable.

25. Meetings should be held between the industry and officials at least quarterly and more frequently if there are substantial problems, to discuss matters arising from the results, check on action taken by the industry to stay on course in spite of changing circumstances, and generally to keep the channels of communication open and working. Where matters of judgement arise, the officials concerned should be sufficiently senior and expert to discuss these on equal terms with the top management of the industries; such discussions need not be restricted to the formal meetings.

26. In the CPRS's view the Sponsor Department should be the main point of contact with the industry. But in order to fulfil their responsibilities, the Treasury and proposed Ministerial Committee Secretariat should, as a matter of course, receive copies of papers from the industry that affect finance and strategy; these would generally include the Corporate Plan, Budget and monthly results. In addition, they should be permitted to attend the regular meetings if they wish, but this should not usually be necessary. It is important that at the monitoring meetings the Government's view should be put across to the industry in a coherent way. Officials should take care to present a united front to the industry and settle any differences they may have elsewhere.

27. Sponsor Ministers and Treasury Ministers should be kept up-to-date with a monthly summary of results for each industry in a standard format. Normally, there would be no need for this report to be more than a single-page summary table of results, with a short, punchy covering note bringing out only the important points. If there were problems, the ad hoc full "exception" reports that are made now should, of course, continue.

28. Similar, consolidated reports for all industries together should be prepared for Ministers to discuss collectively, though quarterly rather than monthly reports would probably be adequate. These reports should show the main results, covering profit and loss, sales etc. as well as cash (EFL). The results should be compared with those of last year and with phased budgets. Here again, reports on major problems in a single industry should be circulated separately.

29. We believe that some of the information coming to Whitehall may be unnecessary and could be cut out, saving the time of industry and Government officials. The CPRS questions, for example, whether it is necessary to monitor BR's weekly cash position indefinitely.

30. The regular provision of comprehensive reports by the industries should not be an onerous task. It simply requires them to put together in order the internal information which should already be available to them for the purposes of managing their businesses. If it is not available, the industry should be encouraged to improve its management information systems so as to provide the suggested data for itself as well as for Government. In our view these represent the basic minimum items of information that are needed for the efficient running of any enterprise.

Conclusions

31. The CPRS believes that the monitoring framework outlined here would provide Government with the information needed for a better understanding of, and relationship with, the industries, although the details will of course differ in each case. These recommendations are in line with good reporting practice in the private sector; they represent a reasonable basic minimum of information needed in order to have an adequate understanding of developments in each industry.

32. The CPRS therefore recommends that a detailed study should be set in train to bring the Government's monitoring practices for each industry up to this minimum standard. For the industries we have studied, Government has the statutory authority, in the case of BSC, CEGB and BR, and an agreement for BL Limited, to obtain any information and returns about the activities of the industries that it requires. If other industries are in a similar situation, no new legislation would be necessary to implement our proposals.

ANNEX E

INDEPENDENT REGULATORY AUTHORITIES

1. The main theoretical objection to returning nationalised industries to private ownership is that in many cases they are "natural monopolies" - as public utilities the structure of their products and markets is such that there is no efficient way of arranging for competing sources of supply. Hence it is argued that, to avoid exploitation of this monopoly power, ownership must remain in public hands subject to Government regulation and public accountability.

2. In principle an answer to this is to set up a regulatory agency with the power to prevent exploitation by controlling prices. If prices could be set by a separate agency at a level which requires the business to run efficiently in order to make profits, then this should be a complete answer to the argument about monopoly power. If the industry were then privatised, the owners would have the prospect of rewards and risks related to their success in running the business efficiently.

3. A separate regulatory agency can also be seen as an answer to the problem of relations with Government while an industry remains in public ownership. Once prices are set externally at a level which requires efficiency if the industry is to continue and take investment opportunities, then the main reason for Government intervention and target-setting is removed. If Ministers want the Board to act against its own commercial judgement (eg to keep open "non-commercial" railway routes), they must negotiate a deal with the Board with a level of grant to make this possible. Since the return on investment depends on cost and demand factors which leave the risk with the Board once the "efficient" price has been set by the agency, there seems no reason in principle why the industry should not raise capital in the market, on equity terms, outside the PSBR; (admittedly the Government would not let the industry cease trading, but it might make it clear that private investors would lose their capital if results were bad enough).

4. However, there are a number of practical difficulties in setting up a regulatory agency; for it to be worth serious consideration, answers would have to be found to several difficult questions:-

(i) Prices. What would be the statutory criteria on the basis of which the agency would determine prices? Clearly the present "break-even" test is inadequate, and more sophisticated tests, such as long-run marginal costs, are indeterminate and require judgement. But more serious, in a monopoly situation no method of determing prices based on costs can ensure efficiency - inefficient practices and high costs can simply be loaded on to prices. Hence the agency must get behind costs in order to judge efficiency.

(ii) Costs. On what basis could the agency determine the level of costs which was "necessary" or "efficient"? It could employ consultants to judge efficiency, but there would be no objective basis for deciding differences of opinion between it and the industry's own managers, so that the industry's rate of return would depend on its judgement. Experience with the Price Commission shows some of the difficulties. If the industry could be split into regions and their costs compared, this might be thought to give a better base for setting prices. But such cost comparisons are always difficult, because differences will at least partly be due to external factors;(how much help is the existence of the two Scottish Boards in reaching decisions on electricity prices?) If the smaller units were genuinely competing with each other, this would be a better test, but in the standard public utility case this is unlikely.

(iii) Wages. How would the agency decide an appropriate level of pay to be allowed for in prices? This is a case of the general difficulty about costs. But it also raises the question how far the agency (and hence the industry which would be carrying on the actual negotiations) would be required to take account of any pay guidelines set by the government of the day. A regulatory agency could in practice do little to hold back excessive pay rises resulting from the exercise of union monopoly power.

(iv) Investment. What criteria would be set for the agency to determine the contribution to be made from current revenue towards finance for new investment? This involves both the tests for appraising new investment (required rate of return) and the self-financing ratio (ie proportions to be raised from revenue and from external borrowing).

(v) Accountability. How far would the agency be subject to direction from Ministers and/or from Parliament? Unless satisfactory guidelines could be devised to limit its discretion, its exercise of this discretionary power would need to be kept in check by some form of accountability. But it must be doubtful whether Parliamentary accountability could bring to bear the necessary technical skill and commercial judgement. And if the Government itself retained power to over-rule the agency, this would in effect simply interpose an extra layer of authority in the present system.

(vi) Relationship with MMC. Could the MCC take on this task, or would a separate agency be needed? The MMC's public quasi-judicial method of proceeding would not fit easily into this new role, and certainly there would need to be a radical extension of its statutory functions and powers.

5. Although we have not been able to examine these questions in depth, we have looked at experience of regulatory agencies in the United States and have consulted a few people with direct experience. Among the main points are:-

(i) State regulatory agencies have generally not been given clear economic criteria as a basis for determining prices. Hence in practice they are required to balance between different vested interests, and cannot confine themselves to considerations of economic efficiency. As a result different interest groups attempt to influence the agencies through litigation. In many instances this has resulted in long drawn out and costly legal proceedings and serious delays in arriving at final decisions. Some US electricity utilities are facing bankruptcy because price applications of some years ago have not yet completed their progress through the courts.

(ii) Their main economic yardstick has been return on capital, rather than efficiency, although they can look into questions of the inefficient use of capital, and can attempt to influence operating efficiency. They sometimes commission outside studies, but do not appear to rely much on comparisons with public utilities in other States.

(iii) State regulation of local electricity undertakings creates problems when groups of undertakings seek to pool their generating facilities to improve efficiency and reduce the risks in constructing large units with long lead-times in the face of uncertain future demands.

Our initial impression was that experience in the United States, though no doubt of some relevance, is not reassuring and certainly does not offer a ready-made blueprint for the operation of a regulatory agency in the UK.

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PRIME MINISTER

CPRS STUDY OF RELATIONS BETWEEN GOVERNMENT AND NATIONALISED INDUSTRIES

Your minute of 4 August invited Ministers responsible for nationalised industries to submit proposals for rapidly increasing business understanding and expertise within their Departments.

I propose to build up business expertise at senior and middle management levels in a way which will directly strengthen the competence of the Department's relevant dealings with the industries, win their confidence in this enhanced capacity and yet not undermine the allocation of clear responsibility for the totality of business, political and social considerations which characterise the relationship between nationalised industries and Government. I propose both to create a central source of financial and commercial expertise and to strengthen commercial attitudes and expertise within policy making areas. The attached paper explains my approach in more detail. These proposals will entail a requirement for about 10 additional posts, mainly inward secondments or people on period appointments. I am advised that finding even 10 extra posts from within the staff ceilings approved for my Department may not be possible. I will be reviewing the D/Energy staff situation over the next few weeks and meantime therefore must keep open all the options regarding this new commitment.

May I add one general comment. To extract maximum gain from our enhanced business expertise, we need to ensure that it is available right through the system for controlling the nationalised industries. The new Ministerial Committee and its support staff will have an important role to play in evaluating priorities between the different industries and, in particular, in the collective consideration of

/proposals

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proposals for public investment. I therefore hope that Geoffrey Howe might also be able to call on enhanced resources for the Treasury's crucial role overall.

I am copying this minute to recipients of yours.

Secretary of State for Energy

17 September 1981

CONFIDENTIAL

DEVELOPING BUSINESS EXPERTISE WITHIN THE DEPARTMENT OF ENERGY

The CPRS study of the Government's relationships with nationalised industries concluded that sponsor Departments needed to develop their capacity to evaluate the nationalised industries' proposals and performances from a business standpoint. This note sets out my proposals in this respect.

The Task

The Department of Energy supervises three major nationalised industries (gas, coal and electricity) in addition to its responsibilities for BNOC, the UKAEA, and BNFL. Supervision of public bodies accounts for about half of the Department's work. Other tasks eg negotiations with oil companies and the placing of research contracts, call for a high order of financial expertise.

At the same time, proposals and developments which need to be assessed with an experienced business eye usually have sensitive social and political implications, eg decisions on fuel prices. The CPRS proposals to concentrate financial expertise primarily in separate business groups could detract from the development of properly integrated policies which reflected adequate consideration of problems from all standpoints. Business skills should be injected into the heart of the Divisions responsible for the industries as a whole.

A plan for the Department of Energy should:-

a. provide a high level of financial expertise to be applied wherever it is needed within the Department;

b. introduce financial expertise into those Divisions which exercise overall responsibility for the major nationalised industries;

c. ensure that overall Divisional responsibility for policy towards an individual industry is not split, but rests unambiguously with the specialist Division.

The Current Position

Over recent years various measures have been taken to develop the Department's business capability:

a. Recruitment of direct entry Principals

A significant proportion of the middle management grades were recruited through the direct entry Principal competitions. Many had extensive industrial experience. The top three posts in the Gas Division are now filled by people recruited in this way who can draw on a combined experience of over 20 years with BP, Texaco and Unilever.

b. Secondments

These have been arranged both directly to the nationalised industries and to private industry. The current Head of Electricity Division was seconded for 18 months into the post of Deputy Chairman and Chief Executive of the Midlands Electricity Board. Current secondments include an Assistant Secretary with British Aerospace and a Principal with the New York merchant bank, Goldman Sachs.

c. Part-time Directorships

These yield experience of and insight into the working of private industry. Four have been arranged so far for Under Secretaries and Assistant Secretaries from nationalised industry Divisions and the Atomic Energy Division.

d. General Numeracy

Administrative grades in the Department of Energy already include an unusually high proportion with analytical and numerical skills (scientists, engineers, mathematicians, economists, etc educated to degree level and beyond). Of total administrative staff at Principal level and above, over 40% have such qualifications.

There already exists a sound base on which I intend to build further.

Further Steps

I propose the following measures:-

a. to designate posts at middle management level in the Gas, Electricity and Coal Divisions to be filled by people with relevant experience in corporate finance, seconded or recruited from the private sector if necessary. Their job would be to monitor and evaluate the commercial and financial performances of the industries;

b. to establish a small core of specialist financial and industrial expertise, to work closely with the nationalised industry Divisons and to provide expertise and advice wherever it is needed on other activities in the Department. It would be led, at a level equivalent to the head of a nationalised industry division (Under Secretary) by someone with relevant experience in the business world, recruited on secondment or period contract;

c. to increase the number of outward secondments of Principals to enable them to gain deeper experience of industrial and commercial problems. This will build up to a cadre of expertise for the future to be deployed in nationalised industry and other Divisions.

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The main task of developing policies towards the individual nationalised industries would remain with the Divisions currently responsible. This recognises the fact that the financial and commercial actions of the industries have an important political dimension and cannot be considered in isolation. The nationalised industry Divisions would however be significantly reinforced both internally and by the business unit.

Implications for Staff Numbers

Such a build-up of the Department's capacity would have implications for staff numbers and costs. (This was recognised in relation to the CPRS proposals at your discussion on 4 August). To the extent possible we would seek to balance inward recruitment by further outward secondments. But we shall need for this task about 10 people, at an estimated cost of about £300,000 p.a for the cost of salaries, superannuation and national insurance contributions.

Department of Energy

17 September 1981

MANAGEMENT IN CONFIDENCE

DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB
01-212 4581

THE PERMANENT SECRETARY
SIR PETER BALDWIN, KCB

Sir John Herbecq KCB
Civil Service Department
Whitehall
London
SW1A 2AZ

15 September 1981

Dear John,

CPRS REPORT ON NATIONALISED INDUSTRIES AND GOVERNMENT

Thank you for sending me a copy of the letter which you wrote to Peter Carey on 17 August about the desirability of arrangements to ensure sufficiently long postings and sufficiently deep specialisation within the civil service, particularly in posts dealing with nationalised industries.

I think I should say, first, that nearly all the policy activity of the Department of Transport, and much of its professional activity also, brings it into direct contact with industry. The nationalised transport industries, including those which are to go private, are a very important part of the Department's responsibilities. But we are also a major client of the civil engineering industry, whose affairs we have to understand pretty intimately. Our activities also impinge a great deal on all those industries which produce equipment for transport, not just the vehicles but all the services which they need, the signalling systems and so on. Across the whole of this field we are also much concerned to do all that we can to assist British industry to improve its grip on export markets. So for us knowledge of industry and commerce is important, and it has been much in our minds in the postings of our administrative staff, though these must be conducted in the wider framework of the establishment which we operate in common with the Department of the Environment.

In the case of professional staff, the scope for movement is not so wide. Many of our professional colleagues have had experience in

the private sector before joining the Service, but I think that here, too, we may have to give greater attention in future to secondment and to training which will help to widen their understanding of the industrial and commercial world.

We have been pursuing a policy of seconding administrative staff in the ranks up to and including Assistant Secretary to industry and commerce, including banks and finance houses. We shall continue with this, though I have to say that it costs a great deal of effort to secure satisfactory results, and we get a very poor response from industry and commerce to invitations to send any of their people to us.

Turning now to the length of postings, we have felt the need to try to keep key figures in the nationalised industries' sector in post for longer than most of us would expect in civil service postings at these levels generally. The Deputy Secretary has been in post for five years, with periods of experience with the nationalised industries previously at Under Secretary level both in this Department and in the Treasury. The Under Secretary on railways has been in post for over five years, and the Under Secretary now in charge of ports has handled their affairs for over ten years. The other two Under Secretaries, in charge of the Directorates covering road passenger and freight transport, have each been in post for over two years and if they are moved in the near future it will be because of the effects of reducing and concentrating our staffing rather than for reasons of career planning.

But in recording the fact that a number of our key people have been in post a long time there is as much worry as credit to be noted. These senior posts usually demand men and women of considerable ability and by retaining them for long periods in these Nationalised Industry posts we run the risk of starving other parts of the Department of the talent they need. (This is less of a problem in the lower ranks but we must still ensure a reasonable distribution of talent.) Moreover, it is troubling that with the best will in the world the promotion prospects for some of the more senior people may have been impaired because they have remained for too long in the one area. I sincerely hope that the effort which this Department, like all others, is putting into career planning will help to avoid this frustrating

experience in future, even if we have to devote still more time to making the best of the talent, experience and opportunities across the Service as a whole.

My conclusion from all this is that while those Departments which have direct responsibility for nationalised industries must attend very carefully to the manning of posts through which this responsibility is discharged, it would be a mistake for us to concentrate so much attention on this one aspect of Government relations with industry as to underplay the need for staff over much wider areas of Government business to acquire a reasonable degree of understanding of the world of industry and commerce, including finance. So I would hope that we could deal with the needs effectively by keeping this point in mind in our procedures for career planning confined to our relations with the nationalised industries alone.

I am sending copies of this letter to those who received copies of Robert Armstrong's letter of 5 August.

Yours ever

PBC

PETER BALDWIN

cc Mr Knight (LO)

From the Secretary of State

PRIME MINISTER

SPONSORSHIP OF NATIONALISED INDUSTRIES

You minuted me on 4 August following up our discussion earlier in the day of the CPRS report on the relationship between Government and the nationlised industries, and asked me and other colleagues concerned to let you know how we propose to improve the expertise and effectiveness of our staff involved in the sponsorship of nationalised industries.

The Department of Trade is responsible for two nationalised industries - the British Airports Authority (BAA) and British Airways (BA).

BRITISH AIRPORTS AUTHORITY

Our relationship with British Airports Authority is very good and creates few problems on the commercial side. This is largely the result of the restricted and clearly defined role of the Authority, which consists essentially of selling services to a limited number of airlines. It is profitable and efficiently managed. It was a pioneer among the nationalised industries in producing current cost accounts, and one of the first to adopt explicit objectives for improving its performance. Commercially it has shown considerable enterprise in maximising its revenues, particularly from commercial concessions.

The main problems which occur in BAA's relations with the Department are political in nature rather than commercial. They arise over matters like the development of additional airport capacity for London, and the lawsuit brought by 17 airlines over landing charges, in which the Department has been joined as a co-defendant.

From the Secretary of State

BRITISH AIRWAYS

With British Airways the situation is much more difficult. Their problems are not unlike those of Pan Am: fierce competition compounded by the effects of a deep economic recession, and the consequences of failing hitherto to carry through successfully a merger between two formerly separate airlines.

The pressure to find a cure in Pan Am's case is provided by the threat of bankruptcy. With British Airways we are endeavouring to apply an equivalent pressure through the strict application of external financing limits and our intention to privatise. The achievement of these objectives depends entirely on the presence of business talent within the airline itself. We have recently appointed a new chairman, Sir John King. He knows that his reputation is committed to a major improvement in BA finances. We have supported him by adding to the Board two men of his choice; and if - as I expect him to do - he asks for a new Finance Director, we shall have to be prepared to pay a salary adequate to get someone of the right calibre.

We are seeking to improve the dialogue between the airline and the Department on financial matters and more generally, so that we understand better the thinking that underlies their management decisions. I do not expect any difficulties with Sir John over this, but BA have been much less willing than BAA to take us into their confidence. However apart from finance the most important interchanges between BA and the Government take place, as with BAA, on the external factors affecting the airline's operations and in particular the Government's aviation policy to some aspects of which they are publicly hostile. I have in mind their opposition to our airports policy and to the liberalisation of licensing policy. These are essentially political matters in dealing with which greater business experience within the Department would not be of particular assistance.

From the Secretary of State

STAFF

The sponsoring division is much smaller than is to be found in the major sponsor Departments, and I think has much in common with the CPRS concept of a business group. We post to the division staff with experience of aviation and business, gained either outside or within government, including staff from the division concerned with conducting international negotiations over traffic rights. Thus the Under Secretary has had previous experience as a pilot and air traffic controller, and has spent a substantial part of his civil service career in work connected with various aspects of aviation. The Assistant Secretary dealing with British Airways has spent two thirds of his twenty years as a civil servant on work related to civil aviation.

As for training, staff have attended courses, specifically related to aviation, at the London Business School and City University, as well as internal courses run by BAA and BA themselves. More widely the Under Secretary has attended a general management course at the Manchester Business School; and the Principal dealing with British Airways has been given direct industrial experience through a six months secondment earlier this year as personal assistant to the Managing Director of Scott-Bader. The team includes a full-time accountant and part-time economists and lawyers.

We recognise the need to do more to increase the staff's knowledge and experience of the industry and of business practice generally. We are therefore at an advanced stage in discussions with British Airways for the secondment of a Principal to them for a long enough period to give him first hand experience of working as part of the airline management. The nature of our problems with our two industries persuades me that this approach is more cost-effective than to import one or more businessmen into the Department, particularly since we hope that before too long we shall be in a position to remove British Airways from the public sector. We shall continue our policy of trying to keep people for longer periods on

From the Secretary of State

this work, though the job of cutting the size of the civil service tends to increase, in the shorter term, the rate at which people need to be moved. In looking for relevant experience outside the aviation field we shall take full advantage of the "common citizenship" between staff in this Department and the Department of Industry.

WJB

W.J.B.

Department of Trade

15 September 1981

Mr T. Lankester

DHSS

With the Compliments of

the Permanent Secretary

DEPARTMENT OF HEALTH AND SOCIAL SECURITY
Alexander Fleming House
Elephant and Castle
London, S.E.1.

MANAGEMENT - IN CONFIDENCE

Not sent as written

DEPARTMENT OF HEALTH & SOCIAL SECURITY
Alexander Fleming House, Elephant & Castle, London SE1 6BY
Telephone 01-407 5522 ext 6981
From the Permanent Secretary
Sir Kenneth Stowe KCB CVO

Sir John Herbecq, KCB,
Civil Service Department,
WHITEHALL,
London SW1

11 September, 1981

Dear Sir John,

CPRS REPORT ON NATIONALISED INDUSTRIES AND GOVERNMENT: LENGTH OF POSTINGS

Thank you for sending me a copy of your letter of 17 August to Peter Carey, in which you accept the aim of securing longer postings and greater specialisation within the civil service, and not only in posts dealing with nationalised industries.

I would certainly endorse this aim, and the outline of your planned report to the Prime Minister. I have already set in hand on my arrival here some arrangements for achieving this. As you say, the succession planning arrangements should help where the open structure is concerned and these will impinge on many Assistant Secretary posts also. I find that over the last few years here we have not in fact moved people about simply for the sake of giving them a change of view. Moves have either been planned because the person concerned had been in the same job for four years or more, or because of unforeseen crises. I have asked my establishments people to adopt as a much firmer aim than hitherto that Under Secretaries should stay in the same posts for at least four years and Assistant Secretaries for at least three, save in very exceptional circumstances, and to consider whether and in respect of what posts we should aim for a longer stay. I can understand that the Prime Minister and her colleagues may think four years too short as a base, but I hope you will be able to convince them that hard practicalities (including the specific requirements set by Ministers) makes it hard to reach even that level of continuity.

I am sending copies of this letter to those who received Robert Armstrong's.

Yours sincerely,

K.R. STOWE

(dictated by Sir Kenneth & signed in his absence)

MANAGEMENT - IN CONFIDENCE

MANAGEMENT IN CONFIDENCE

Dogmd. Walker Natg

Department of the Environment
2 Marsham Street London SW1P 3EB
01-212 8051

The Permanent Secretary
G W Moseley CB

Sir John Herbecq KCB
Civil Service Department
Whitehall
LONDON
SW1

7 September 1981

Dear John.

CPRS REPORT ON NATIONALISED INDUSTRIES AND GOVERNMENT

In your letter of 17 August to Peter Carey you ask a number of questions about the proposed response to the Prime Minister's request for proposals to secure longer postings and greater specialisation within the Civil Service.

My comments must, of course, be read against the background of our common citizenship with the Department of Transport.

Basically I am in agreement that, within certain limits, longer postings and greater specialisation are in principle desirable at higher as well as lower levels but the problems in achieving this must not be under-estimated.

To answer your specific questions. I do not think it desirable to introduce additional machinery to deal with nationalised industry posts. While the new succession planning arrangements will help us to achieve sensible career sequences it must be left to Departments to weave the needs of the nationalised industry posts into the wider fabric of their complete manpower needs. The most that I would

suggest is that CSD should stand ready and willing to help to arrange inter-departmental exchanges of staff to gain wider experience of handling various nationalised industries' affairs. Secondly, I would prefer not to introduce some special status for nationalised industry related posts. The need for less turbulence and greater specialisation is probably just as important in other key areas as, indeed, your own letter suggests. The problem of rapid turnover, particularly among fast streamers, is certainly not confined to the N.I. posts but is widespread. Finally, it is true that a system of specialisation is easier to implement in the lower ranks as you suggest although we must provide a way to encourage and bring on the more able people and not allow them to stultify.

So much for the facts. The problem is how to achieve the end the Prime Minister seeks. While I do not disagree with the general line you propose to take in your eventual report, I do not think your letter fully recognises all the problems that will arise. In the nature of things the best people are in the greatest demand and must not follow too narrow a career if they are to be adequately prepared for higher responsibilities. How can we ensure (and convince the Service generally) that a greater degree of specialisation will not damage existing career prospects? One way might be to identify circuits of related posts within and between Departments within which officers would move at fairly regular intervals while using and extending their knowledge of a particular field e.g. Nationalised Industries or Local Government. I believe we could do this fairly easily within DOE and DTp (indeed we already do so) but it may not go far enough towards meeting the kind of objectives Ministers have in mind. If the "specialisation" is to be narrower then we may have to consider whether we need to devise a means of ensuring that the concentration on a specific area of the Department's work does not adversely affect an individuals opportunities for promotion.

As a separate but related issue we might also need, in the short term at least, to reconsider our retirement policy and be prepared to retain beyond 60 more people at various levels who offer the continuity of experience we seek and whose rentention would reduce the turbulence foreseen in the next few years.

I also suggest that the report to the Prime Minister should underline the risks that, if we favour certain parts of the Department by permitting the lengthy retention of first class people, other areas will suffer. With our tauter complements we can ill afford to try to operate parts of the Department with an undue proportion of the less able.

I am sending copies of this letter to those who received yours.

Yours ever

George

G W Moseley

CONFIDENTIAL

Ref gd

MINISTRY OF DEFENCE
MAIN BUILDING WHITEHALL LONDON SW1A 2HB
Telephone 01-218 2193 (Direct Dialling)
01-218 9000 (Switchboard)

PERMANENT UNDER-SECRETARY OF STATE
SIR FRANK COOPER GCB CMG

PUS/81/1364
7/33

cc Mr Dugmd
Mr Walker

Sir John Herbecq KCB
Civil Service Department
Whitehall

4 September 1981

Dear John.

I have read with interest Robert Armstrong's letter of 5 August about the CPRS Report on the Relationship between Government and the Nationalised Industries; and your letter of 17 August.

2. Taking the specific issue first. In MOD we have somewhat similar issues in our relationships with individual defence contractors and with their formalised groupings such as the National Defence Industries Council. One factor we notice particularly is that the people who we deal with in industry stay in the same area of work (and particular jobs) much longer than ours do and this is a point industry makes to us and to which we are steadily responding. The need both for greater continuity in individual postings and for a pattern of postings and directly related training has been recognised and we are taking steps to improve our practice on both. You already know about our approach to specialisations within the Administration Group (and professional qualifications related to them). We are also giving added emphasis to project management within the Science Group.

3. All this is, I believe, fully in line with the request by the Prime Minister but my people are very ready to amplify our plans to yours, if you wish.

4. Turning to your more general points, I would not dissent from the thrust of your paragraph 7. We must not overplay the immediate consequence of succession planning. Indeed, in the short-term, better succession could mean more turbulence not less! And we make life very difficult for ourselves by having no training margin, by being very rigid about having to move staff on promotion and having so little flexibility about retirement dates (in these last two areas industry consider us quite bizarre - I agree with them).

5. A copy goes to those who received Robert Armstrong's letter.

Yours ever

FRANK COOPER

CONFIDENTIAL

MFJ

CONFIDENTIAL

20 August 1981

The Prime Minister has seen Mr. King's minute of 13 August, about the CPRS report on the relations between Government and nationalised industries. She has noted his views in relation to the water industry.

MAP

P.J. Cash, Esq
Department of the Environment

CONFIDENTIAL

MANAGEMENT IN CONFIDENCE

Nat Ind

MAP

CIVIL SERVICE DEPARTMENT

WHITEHALL LONDON SW1A 2AZ

Telephone 01 273 5400

Sir John Herbecq K.C.B
Second Permanent Secretary

17 August 1981

Sir Peter Carey KCB
Department of Industry
Ashdown House
123 Victoria Street
LONDON SW1E 6RB

Dear Peter

CPRS REPORT ON NATIONALISED INDUSTRIES AND GOVERNMENT

In his letter of 5 August to Ian Bancroft (who is at present on leave), Robert Armstrong said that the Prime Minister had asked that the CSD, in consultation with the Departments concerned, should make early proposals on securing longer postings and greater specialisation within the Civil Service, particularly in posts dealing with nationalised industries.

2. Those two aims were, in fact, expressly among those leading to the introduction of the succession planning arrangements which came into force this year. For posts within the new scheme, the possible succession will be scrutinised each year, in regard to both the immediate succession and the next-but-one succession. And most post-holders and their potential successors will have individual career plans prepared for them, giving a forward look over the next 5 years. These arrangements are intended to cover all Open Structure posts, together with Assistant Secretary posts for which Departments think formal succession planning is required. The material relating to Deputy Secretary posts and key Under Secretary posts (and their successors) will come to CSD; the rest will be handled by Departments alone.

3. In principle, this machinery should provide the basis for guarding against too rapid turnover and for planning an appropriate sequence of experience and training, at least down to Assistant Secretary level. But I should be very interested to know whether sponsor Departments feel that some additional piece of machinery may be needed for posts which are dealing with nationalised industries. (One has to keep in mind, of course, the risk of overloading the succession planning system.)

4. Obviously, the existence of the machinery will not of itself produce the desired result, there will have to be a constant battle against the other factors which will tend to intervene. At times of expansion or contraction, additional moves will simply be inevitable, and each move has a ripple effect. Even in times of stability, we have to allow for the

need to give the ablest people varied experience (both inside and outside the Service) and this, coupled with the desire to bring outstanding people on quickly (so that there may be time only for one or two postings within each grade), tends to mean that the most talented cannot spend too long in the one spot. Again, we should be interested to know whether sponsor Departments see a need for some special status for nationalised industry-related posts? (It is possible, however, that such a development could be detrimental to ensuring that such posts received a full share of the best talent.)

5. We are acquiring some up-to-date turnover figures for a sample of representative Departments. At present, it is my belief that where there is a problem of excessive turnover of fast-stream people, it is not in any way peculiar to nationalised industry posts. Would you confirm this? Or did the CPRS encounter some particular weakness in this area which deserves a special attempt to produce greater continuity there?

6. In the main stream, on the other hand, we not infrequently encounter the opposite kind of problem - people spending too long in the one job- and this could become more acute as promotion opportunities dwindle. Much may depend on the Department's posting system. Where moves can be self-generated, the thought that chances of promotion are increased by a varied track record may lead to more rapid turnover. In general, however, it is less difficult in the lower ranks to introduce a system of specialisation in certain fields of work (and some Departments have in fact done so). Would you agree?

7. Our report to the Prime Minister may in the end take the following course:

a. descriptions of the succession planning arrangements for the fast stream and the safeguards they will offer, and of present arrangements in some Departments for introducing a measure of specialisation into main stream work; our intention to secure longer postings and greater specialisation and generally improve the level of professionalism not only in posts dealing with nationalised industries, but also other key policy areas and posts with major responsibility for controlling resources;

b. some account of the factors leading to turbulence, and what can be done about them;

but

c. despite the remedial elements in what has gone before, a confession that for the next few years, taking into account the unavoidable effects of the rundown in numbers, reinforced by chain of command studies, one can predict a considerable degree of turbulence on top of the consequences of the normal moves, many of which cannot be helped - so that we cannot yet promise any dramatic improvements over the Service as a whole, though sponsor Departments will be paying particular attention to their nationalised industry seats.

8. I should be grateful for your views. Your review of the DIT personnel management function may be throwing up some useful pointers, eg how to minimise the risk that the effect of individual turnover may be compounded by turnover of a whole slice of the hierarchy within a short time.

9. I am sending copies of this letter to those who received Robert Armstrong's.

Yours ever

JH

John Herbecq

CONFIDENTIAL

2

Prime Minister

Prime Minister

14/VIII

Prime Minister

The CPRS report on the relations between government and nationalised industries contains much that is relevant to the industries which this department sponsors, even though they are outside the mainstream of nationalised industries. My experience with the water industry makes me favour the use of people with business expertise among those dealing with the industry, because their presence can improve both the government's relations with the industry and the industry's efficiency. I was therefore encouraged to see that the CPRS urged the greater use of businessmen in the staffs working on nationalised industries.

The recommendation that more use should be made of 'efficiency audits' by outside experts also accords with my experience of the water industry. As you know, the Monopolies Commission and consultants have already been employed to study the industry, and I believe that further studies of this kind could be valuable. I am sure there is a great deal of scope for improving performance by encouraging more business-like attitudes in the water industry.

While the recommendations of the CPRS are not all applicable to the water industry with its rather different structure, the spirit of them is certainly very relevant and very much in line with our own thinking.

TOM KING

13 August 1981

CONFIDENTIAL

HL

Not ind
copied to
J Buckley
CSO
Employment.

10 DOWNING STREET

From the Private Secretary

6 August 1981

Dear Peter,

I enclose the record of the meeting which the Prime Minister held on Tuesday 4 August to discuss the CPRS report on the relationship between Government and the nationalised industries.

I am sending copies of this letter and enclosure to John Rhodes (Department of Trade), Julian West (Department of Energy), Richard Riley (Department of Industry), Godfrey Robson (Scottish Office), Anthony Mayer (Department of Transport), David Edmonds (Department of the Environment), David Wright (Cabinet Office) and Gerry Spence (CPRS).

Yours ever,

Tim Lankester.

Peter Jenkins, Esq.,
H.M. Treasury.

CONFIDENTIAL

3 FP

SUBJECT Copied to Master.

CONFIDENTIAL

NOTE OF A MEETING HELD AT 10 DOWNING STREET ON TUESDAY 4 AUGUST AT 1000 TO DISCUSS A REPORT BY THE CENTRAL POLICY REVIEW STAFF ON THE RELATIONSHIP BETWEEN GOVERNMENT AND THE NATIONALISED INDUSTRIES

Present

The Prime Minister
Chancellor of the Exchequer
Secretary of State for Trade
Secretary of State for Energy
Mr. Norman Tebbit
Mr. Michael Marshall
Mr. Alex Fletcher
Mr. Kenneth Clarke
Mr. David Young
Mr. J.R. Ibbs
Mr. J. Hoskyns
Sir Robert Armstrong
Mr. P.L. Gregson
Mr. D.J.L. Moore

* * * * * * * * * * *

Mr. Ibbs said that the Central Policy Review Staff (CPRS) had found that, apart from the economic conditions which had affected financial results in all sectors of industry, there were five basic problems in the present arrangements for the nationalised industries: the lack of market forces and any threat of bankruptcy; the extent of union power; the absence of a sufficient strategic framework; the impact of political decisions which unavoidably clashed with straightforward business objectives; and a failure of communication and understanding between the industries and their sponsor departments. To make it possible to tackle these problems more effectively, the CPRS recommended four main courses of action. First, each chairman on appointment should be given a set of clear strategic objectives which should only be altered after discussion and after definition of the business consequences of any change. Secondly, the boards of the industries should be generally small with a

/majority

majority of non-executive directors acting as a surrogate for absent market forces. Thirdly, in each of the main sponsor departments there should be a separate business group, looking after all the department's industries, and headed initially by a businessman at second permanent secretary level. Fourthly, a small Ministerial committee should be set up, which the Prime Minister might chair, to consider issues of nationalised industry policy and with the support of a small review staff including people with business experience and working closely with the Treasury. These general proposals and principles would need to be tailored to the particular circumstances of the individual industries.

In discussion there was general agreement with most of the CPRS recommendations. The following were the main points made:-

(a) The business expertise of the sponsoring departments should be developed urgently, but not necessarily by setting up business groups headed by a senior businessman. It would be difficult to find enough people of the right calibre to take on this role. There was a danger that they would impede rather than improve good relations between the chairmen and Ministers; this had been a criticism of the role of the National Enterprise Board. In practice it could be difficult to draw a line between business issues on the one hand and political and administrative questions on the other. Insofar as suitable businessmen were available, it might be better to recruit them directly to the nationalised industries either in a full-time capacity or as non-executive directors.

(b) An alternative way of building up the business expertise of the sponsoring departments would be to recruit middle ranking outsiders with the right experience - businessmen, merchant bankers or accountants - into executive roles on a short-term contract of, say, three or five years. At the same time the business

/expertise

expertise of the civil servants in sponsoring departments could be developed by ensuring that they had the right training, including secondments to outside industry, and that full and effective use was then made of their experience. At present junior staff in particular tended to be kept in post for little more than two years; this was insufficient if they were to gain in-depth understanding of the industries with which they dealt. The Civil Service Department and sponsoring departments should take action to change this practice. Increased business acumen in the sponsoring departments would improve their relationship with the industries who would have a greater respect for them; although some chairmen would continue to be critical of civil servants who, in their view, were insufficiently compliant with their wishes.

(c) Smaller boards with a majority of non-executive directors would probably be right for most of the nationalised industries. For some, a different structure might be appropriate with, for example, a main board over a number of limited companies each with its own objectives and External Financing Limits. There might also be scope for breaking some of the large industires into regional groupings.

(d) It was agreed that there was no case for a Ministry for the Nationalised Industries. The better course was to set up a Ministerial Committee supported by a small review staff located in the CPRS.

The Prime Minister, summing up the discussion, said that the meeting congratulated the CPRS on their excellent report. They agreed that each chairman should be given a set of clear strategic objectives on appointment; that there should be a move to smaller boards with, in most cases, a majority of non-executive directors; that there should be a new committee to consider issues of nationalised industry policy which she would chair, with the Chancellor of the Exchequer deputising for her as appropriate; and that the Ministerial Committee should be

/supported

supported by a small review staff in the CPRS, which would involve a net addition to the staff numbers of the CPRS and of the Cabinet Office. The meeting also agreed that the business expertise of the sponsoring departments should be developed urgently, but they were not fully persuaded by the CPRS proposals for business groups headed by a senior businessman. Each sponsoring Minister should therefore suggest in detail how they would wish to give effect to the CPRS recommendations and, in particular, to improve the expertise of their departments in dealing with the nationalised industries; the meeting recognised that the arrangements would need to be tailored to the particular needs of the individual industries. She would also arrange for the Civil Service Department to make proposals for ensuring that officials who dealt with nationalised industries should spend longer in each post and that they should have career paths providing for more business training and a succession of postings to build up and reinforce their expertise in this work. There was strong interest in the CPRS report both among the nationalised industry chairmen and from the press; the meeting agreed that in principle there was a case for publishing the report, perhaps with some amendments, but they would consider this further in the light of the firm decisions which would be taken later on how to respond to the CPRS recommendations.

The Meeting -

(1) welcomed and approved the CPRS report, and endorsed its recommendations on defining objectives, and on the size and composition of nationalised industry boards;

(2) took note that the Prime Minister would invite each sponsoring Minister to put forward his detailed proposals for implementation of the CPRS recommendations for improving the expertise of sponsoring departments, and would make arrangements to set up a Ministerial Committee and a small review staff in the CPRS, on the lines recommended by the CPRS;

/ (3)

(3) agreed to resume their discussion of the CPRS report in the light of the written submissions from sponsoring Ministers.

6 August 1981

From the Secretary of the Cabinet

Done

OK.

Mr Lankester. 12

6/8

You will wish to approve and then distribute this record of Tuesday's meeting.

J. Wyatt

6/8

CONFIDENTIAL

Note of a meeting held at 10 Downing Street, on Tuesday 4 August 1981 at 10:00am, to discuss a report by the Central Policy Review Staff on the relationship between Government and the Nationalised Industries.

Present

The Prime Minister

Chancellor of the Exchequer

Secretary of State for Trade

Secretary of State for Energy

Minister of State,
Department of Industry (Mr Tebbit)

Parliamentary Under Secretary of State,
Department of Industry (Mr Marshall)

Parliamentary Under Secretary of State,
Scottish Office (Mr Fletcher)

Parliamentary Under Secretary of State,
Department of Transport (Mr Clarke)

Mr David Young,
Department of Industry.

Mr J R Ibbs,
Central Policy Review Staff.

Mr J Hoskyns,
Policy Unit, No 10 Downing Street.

Sir Robert Armstrong.
Mr P L Gregson.
Mr D J L Moore.

MR IBBS said that the Central Policy Review Staff (CPRS) had found that, apart from the economic conditions which had affected financial results in all sectors of industry, there were five basic problems in the present arrangements for the Nationalised Industries: the lack of market forces and any threat of bankruptcy; the extent of union power; the absence of a sufficient strategic framework; the impact of political decisions which unavoidably clashed with straightforward business objectives; and a failure of communication and understanding between the

CONFIDENTIAL

industries and their sponsor departments. To make it possible to tackle these problems more effectively, the CPRS recommended four main courses of action. First, each chairman on appointment should be given a set of clear strategic objectives which should only be altered after discussion and after definition of the business consequences of any change. Secondly, the boards of the industries should be generally small with a majority of non-executive directors ~~generally~~ acting as a surrogate for absent market forces. Thirdly, in each of the main sponsor departments there should be a separate business group, looking after all the departments' industries, and headed initially by a businessman at second permanent secretary level. Fourthly, a small Ministerial committee should be set up, which the Prime Minister might chair, to consider issues of nationalised industry policy and with the support of a small review staff including people with business experience and working closely with the Treasury.

These general proposals and principles would need to be tailored to the particular circumstances of the individual industries.

In discussion there was general agreement with most of the CPRS recommendations. The following were the main points made:-

(a) The business expertise of the sponsoring departments should be developed urgently, but ~~would~~ not necessarily ~~best be done~~ by setting up business groups headed by a senior businessman. It would be difficult to find ~~someone~~ enough people of the right calibre to take on this role. There was a danger that they would impede rather than improve ~~good direct~~ relations between the chairmen and Ministers; this had been a criticism of the role of the National Enterprise Board. In practice it could be difficult to draw a line between business issues on the one hand and political and administrative questions on the other. Insofar as

suitable businessmen were available, it might be better to recruit them directly to the nationalised industries either in a full time capacity or as non-executive directors.

(b) An alternative way of building up the business expertise of the sponsoring departments would be to recruit middle ranking outsiders with the right experience - businessmen, merchant bankers or accountants - into executive roles on a short term contract of, say, three or five years. At the same time the business expertise of the civil servants in sponsoring departments could be ~~built up~~ developed by ensuring that they had the right training, including secondments to outside industry, and that full and effective use was made of their experience. ~~as it developed.~~ At present junior staff in particular ~~were~~ tended to be kept in post for little more than ~~around~~ two ~~or three~~ years; ~~and~~ this was insufficient if they were to gain in depth understanding of the industries with which they dealt. The Civil Service Department and sponsoring departments should take action to change this practice. Increased business acumen ~~or~~ in the sponsoring departments would improve their relationship with the industries who would have a greater respect for them; although some chairmen would continue to be critical of civil servants who, in their view, were insufficiently compliant with their wishes.

(c) Smaller boards with a majority of non-executive directors would probably be right for most of the nationalised industries. For some, a different structure might be appropriate with, for example, a main board over a number of limited companies each with its own objectives and External Financing Limits. There might also be scope for breaking some of the large industries into regional groupings.

(d) It was agreed that there was no case for a Ministry for the Nationalised

Industries. The better course was to set up a Ministerial Committee supported by a small review staff located in the CPRS.

THE PRIME MINISTER, summing up the discussion, said that the meeting congratulated the CPRS on their excellent report. They agreed that each chairman should be given a set of clear strategic objectives on appointment; that there should be a move to smaller boards with, in most cases, a majority of non-executive directors; that there should be a new committee to consider issues of nationalised industry policy which she would chair, ~~although she would invite~~ with the Chancellor of the Exchequer ~~to~~ deputising for her ~~from time to time~~ as appropriate; and that the Ministerial Committee should be supported by a small review staff in the CPRS, ~~with the~~ which should involve a net addition to the staff numbers of the CPRS and of the Cabinet Office ~~increased accordingly~~.

The meeting also agreed that the business expertise of the sponsoring departments should be developed urgently, but they were not fully persuaded by the CPRS proposals for business groups headed by a senior businessman. ~~In the light of further advice from Mr Ibbs, she would invite~~ Each sponsoring Minister ~~to~~ should prepare supplementary advise in detail how they would wish to give effect to the CPRS recommendations and, in particular, to improve the expertise of their ~~staff~~ department in dealing with the nationalised industries; the meeting recognised that the arrangements would need to be tailored to the particular needs of the individual industries. She would also arrange for the Civil Service Department to make proposals for ensuring that officials who dealt with nationalised industries should spend longer in each post ~~than the present average 2 or 3 years~~ and that they should have career paths providing for more business training and a succession of postings to build up and reinforce their expertise in this work. There was strong interest in the CPRS report both among the nationalised industry chairmen and from the press; the meeting agreed that in principle there was a ~~strong~~ case for publishing the report, perhaps with some amendments, but they would consider this further in the light of the firm decisions which would be taken later on how to respond to the CPRS recommendations.

THE MEETING -

2. Took note that the Prime Minister would invite each sponsoring Minister to put forward his detailed proposals for implementation of the CPRS recommendations for improving the operation of sponsoring departments, and would make arrangements to set up a Ministerial Committee and a small central staff in the CPRS, on the lines recommended by the CPRS.

3. Agreed to resume their discussion of the CPRS report in the light of the written submissions from sponsoring Ministers.

1. Welcomed and approved the CPRS report, and endorsed its recommendations on defining objectives, and on the size and composition of nationalised industry boards, ~~and on the need to set up a Ministerial Committee~~

CONFIDENTIAL

1. Mr Rickett
2. Private Secretary

This is the letter you asked Robert to write about the length of postings.

CABINET OFFICE

70 Whitehall. London SW1A 2AS Telephone 01-233 8319

From the Secretary of the Cabinet: Sir Robert Armstrong KCB, CVO

Ref: A05393

5th August, 1981

The CPRS Report on the Relationship between Government and the Nationalised Industries includes several recommendations designed to make sponsor Departments more effective in dealing with their industries. Certain of these recommendations, for example the setting up of Business Groups within Departments led by senior businessmen, are to be examined further in the light of the views of Ministers on how to improve the arrangements within their particular Departments. But one recommendation which commanded general support at a meeting of Ministers on 4th August is that officials who deal with nationalised industries should spend longer in each post than at present - it was suggested that particularly at relatively junior levels postings usually lasted little more than two years - and should have a career path providing for more business training and a succession of postings to build up and reinforce their expertise in this work.

The Prime Minister has asked that the CSD, in consultation with the Departments concerned, should make early proposals for giving effect to this recommendation. Indeed, I think that she is inclined to the view that Civil Service postings could with advantage be longer as a general rule, not just in this area; and that there could with advantage be greater specialisation in career patterns, so that even with a reasonable degree of mobility between jobs there would be greater opportunities than there sometimes seem to be at present for building up experience and knowledge in a particular line of business.

I am sending copies of this letter to Peter Baldwin, Peter Carey, Ken Clucas, Frank Cooper, Kerr Fraser, Donald Maitland, George Moseley and Ken Stowe; and to Douglas Wass, Robin Ibbs, Tim Lankester and Clive Priestley.

ROBERT ARMSTRONG

Sir Ian Bancroft, GCB

CONFIDENTIAL

CONFIDENTIAL

SUBJECT.

cc: HMT
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10 DOWNING STREET

THE PRIME MINISTER

Personal Minute
No. M 11/81

SECRETARY OF STATE FOR TRADE

This morning we accepted the main recommendations made by the CPRS in their report on "The Relationship between Government and the Nationalised Industries" but agreed that further consideration needed to be given to the proposal on Business Groups. The need for staff in sponsor Departments who are concerned with nationalised industries to have greater experience and understanding of business was accepted; we agreed that each sponsor Department should now put forward proposals on how in their particular situation this greater experience and understanding could be introduced rapidly and brought to bear effectively on the Department's dealings with nationalised industries.

Merely to provide more training on business matters, or to introduce advisers, will not be sufficient. It was clear from this morning's discussion that at each level the civil servants dealing with the industries need to have greater awareness of the business implications of policy issues and be better able to probe and weigh up the arguments put forward by the industries. We have to achieve a change of culture; this means that whatever is proposed must be capable of being sustained and must be organised in such a way that it will not be stifled by the present environment.

/ I should be

055

Trade are not taking the lead — all depts who were sent a copy must be hung.

I should be grateful if you and other sponsoring Ministers could let me have by September 18 proposals for providing new arrangements in your respective Departments that would ensure the necessary change takes place as rapidly and effectively as was envisaged by the CPRS in their proposals on Business Groups.

I am sending a copy of this minute to the Chancellor of the Exchequer, to the Secretaries of State for Energy, Scotland, Industry and Transport (who were at or were represented at this morning's meeting) and also to the Secretary of State for the Environment, the Lord President, Sir Robert Armstrong and Mr. Ibbs.

M.H.T.

4 August 1981

3

CF

10 DOWNING STREET

Prime Minister

Attached the draft minute which you asked PUS to prepare after this morning's meeting.

4/8

Prime Minister

CPRS NATIONALISED INDUSTRIES STUDY

Kenneth Clarke will represent me at your meeting next Tuesday to consider the report. I have now read it, and discussed its main conclusions with Mr Ibbs.

I agree with the analysis and the central recommendations of the CPRS study. Clearly detailed work has now to be done; and this must recognise the different circumstances of different industries and therefore the different relationships with Government. But fast progress along the lines which Mr Ibbs indicates will pay dividends.

Copies of this minute go to the Chancellor of the Exchequer, the Secretaries of State for Industry, Environment, Scotland, Energy and Trade, and to Sir Robert Armstrong and Mr Ibbs.

NORMAN FOWLER

31 July 1981

10 DOWNING STREET

From the Private Secretary

31 July 1981

BF 3/8/81

The Prime Minister has seen your Secretary of State's minute of 28 July, about her meeting next week to discuss the CPRS Report on the Nationalised Industries, which is to be held at 1000 on Tuesday, 4 August.

She would be pleased to have both Mr. Marshall and Mr. Young, in addition to Mr. Tebbit, present at the meeting.

I am sending copies of this letter to Gerry Spence (CPRS) and David Wright (Cabinet Office).

M. A. PATTISON

I. K. C. Ellison, Esq.,
Department of Industry.

Ref. A05352

PRIME MINISTER

Nationalised Industries: 1981 Investment and Financing Review

(E(81) 79 and 81)

BACKGROUND

The Chief Secretary's memorandum (E(81) 79) covers a detailed report by officials on the nationalised industries' investment and financing requirements and gives his recommendations on the steps necessary to deal with the additional bids which have emerged. The CPRS, in E(81) 81, give their suggestions on how to allocate the cuts and on the best tactics for ensuring that they are made.

2. The total additional bids over the provision in the Public Expenditure White Paper (Cmnd 8175) are:

£ billion cash

1982-83	1983-84	1984-85
2.5	3.2	3.0

The £2.5 billion for 1982-83 is part of the total of additional public expenditure bids of £6.5 billion which the Chancellor of the Exchequer has reported to the Cabinet. In practice the industries' additional bids could turn out to be higher on account of the optimistic economic assumptions made by some of them and when the fully-fledged proposals for the British Steel Corporation (BSC), the National Coal Board (NCB), British Rail (BR) and British Shipbuilders (BS) are available. Against this background the Chief Secretary is prepared to accept increases of £750 million in each year in the totals for the nationalised industries so that the net additional bids would then be:

£ billion cash

1982-83	1983-84	1984-85
1.75	2.45	2.25

3. The additional bids are made up partly of bids for additional investment but they are mainly on account of shortfall in internal resources due to a more pessimistic view of market prospects, and hence lower revenue forecasts, by most of the industries. The additional bids for each industry are tabulated in the

External Finance columns of Appendix A Table 1 immediately after the introductory text of the report by officials. Appendix B of their report sets out the details for each industry and shows for most of them (in line 9 of the tables) their assumptions for the increase in their pay bill which is generally related to their own general inflation assumptions.

4. The Chief Secretary points out that it is necessary for sponsoring Ministers to act now in seeking reductions in these additional bids in order to influence in good time the work which the industries will be doing preparatory to firm decisions in the autumn on their External Financing Limits for 1982-83. He puts forward three possible ways of securing the necessary cuts:-

I. To restrict each industry to 85 per cent of the investment level in Cmnd 8175 on the understanding that higher levels of investment would be approved to the extent that they were financed from additional internal resources (the effect for each industry is shown in Table (i) attached to his cover note).

II. To cut the current costs of each industry by 5 per cent in 1982-83 and by 7 and 5½ per cent in the two following years falling back on investment cuts only in the last resort (details in the Chief Secretary's Table (ii)).

III. To cut current costs of most of the industries by 6 per cent in 1982-83 and by 8 and 6 per cent in the two following years but to cut by less the costs of those industries subject to market competition (Table (iii)).

Each Minister would be free to alter the balance of overall savings between the industries for which he was responsible. If the Committee could not agree to either II or III, the Chief Secretary would want to fall back on I.

5. Option I would be the most certain in its effect but, as the CPRS point out in E(81) 81, it seems highly objectionable at a time when Ministers are trying to encourage a higher proportion of capital rather than current public expenditure and when they are looking for employment generating capital investment. Cuts based on reductions in current costs are more attractive in principle and, if possible, it would be better to operate selectively with some regard to priorities rather than

evenly across the board, that is to go for Option III rather than II. The CPRS agree with this and they propose that the aim for each industry should be to find its allocated cuts from a mix of working capital, current costs and fixed investment in that order so as to leave investment as near intact as possible. They go on to make the tactical suggestion that final investment approval (15 per cent in the case of 1982-83) should be withheld from each industry until it produces a detailed plan for delivering the required overall savings.

HANDLING

6. After the Chief Secretary and Mr. Ibbs have introduced their papers you might invite each of the sponsoring Ministers to comment on the proposals - the Secretaries of State for Energy, Trade, Transport and Scotland and the Minister of State, Department of Industry (Mr. Tebbit). The Secretary of State for Employment will probably want to comment on employment implications.

7. In discussion you will wish to give as firm a lead as possible towards a determined effort to find substantial savings; this is essential if there is to be any chance of getting the overall public expenditure overspend down to more manageable levels. At the same time you will wish to look for an outcome which is both practicable and acceptable and to that end you will in general want to steer the sponsoring Ministers to looking for reductions which:-

(i) Avoid capital investment cuts as far as possible (indeed some more employment generating investment would be welcome).

(ii) Avoid letting the monopoly industries buy themselves out of trouble by excessive price increases.

(iii) Take account of industrial realities in industries such as the NCB.

(iv) Focus, as the CPRS suggest, on current costs including wages.

While there is obviously no point in writing down the industries' wage assumptions to unrealistic levels, and the details are for discussion in September, it does seem that some current cost savings could be made from lower wage assumptions. (British Telecommunications are, for example, assuming increases in their pay bill of 14 per cent in 1982-83 and 13 and 11 per cent in the two following years.)

In the light of the discussion the Committee will no doubt form a view on whether it is realistic to meet these 4 criteria and to get the required cuts. In looking at the three options, and as each sponsor Minister gives his views, there will inevitably be some discussion of individual industries but I do not think that you need at this stage to get into details on each and every industry.

8. It may well be that the discussion will point to adopting the Chief Secretary's Option III (selective cuts on current costs) as glossed by the CPRS. Unless a convincing case were made to the contrary this seems the option worth trying on the industries. Obviously it will be difficult and overwhelming practical objections may emerge, but these can be considered later and in the light of the further discussions between sponsoring Departments and their clients.

9. You have a separate meeting on 4th August to discuss the CPRS's longer term report on Government/Nationalised Industry relations.

CONCLUSIONS

10. In the light of the discussion you will wish to record conclusions:

(i) agreeing that an additional £750 million should be made available to the nationalised industries so reducing their additional bids;

(ii) deciding on how to deal with the remaining bids, probably deciding on Option III subject to the points made by the CPRS and perhaps with the reservation that it should be made clear to the monopoly utilities that they cannot propose excessive price increases;

(iii) inviting the sponsoring Ministers to inform their industries of these provisional decisions so that they can take account of them in their proposals in mid-September for their 1982-83 EFLs.

RJA

Robert Armstrong

30th July, 1981

cc Mr Wallers
Mr Wolfson
Mr Ough
Mr Ingham.

1.

Prime Minister

You may like to have a first look at this before the weekend.

MAD 25/VII

CONFIDENTIAL

Qa 05643

To: PRIME MINISTER

From: J R IBBS

In the weekend box please

28 July 1981

Nationalised Industries

1. The attached paper meets the remit to the CPRS to review the relationship between the Government and the nationalised industries, and report before the Recess (Mr Lankester's minute of 3 April). Moves towards privatisation and greater competition, and changes in financing, are outside the remit. In the time available we have concentrated on the larger industries and have not examined the smaller ones nor those sponsored by the Secretary of State for Scotland.

Summary

2. In brief, we have found that apart from the economic conditions which have affected financial results in all sectors of industry, there are five basic problems:

(i) the lack of market forces and any threat of bankruptcy;

(ii) the extent of union power;

(iii) the absence of a sufficient strategic framework;

(iv) the impact of political decisions which unavoidably clash with straightforward business objectives;

(v) a failure of communication and understanding.

3. These problems put a great strain on the relationship between Government and the industries. Improving this relationship will not itself remove all the problems, but it will help in tackling them effectively. Following widespread consultations we find that the situation is serious enough to require early action under three main headings:

a. Objectives

4. However attractive a wholly 'arms length' relationship may be in theory, we are convinced that it is not possible in practice. The Government effectively 'owns' the industries on behalf of the nation. This means that it must set clear objectives for each industry's management, and must

then monitor performance and press for action to correct shortcomings. We attach importance to giving each Chairman on appointment a set of clear strategic objectives which should only be altered after discussion and definition of the business consequences of any change. This should form the basis of a close relationship between the Secretary of State and Chairman. These objectives will then be translated into quantified medium-term targets in the corporate plan and into annual budgets, in turn providing a framework for overall monitoring and remedial action. It is important that detailed management should be left to the industries and that the Government's involvement should be restricted to major issues.

b. The Industries

5. The size and complexity of the principal industries is such that the Chairmen and senior executives need to be industrialists of the highest quality; the financial and other rewards need to be sufficient to attract them. We favour small Boards, with a majority of non-executive directors. The latter need to have had relevant experience outside the industries and must bring a probing but well balanced approach to their role. They should be given explicit responsibilities, e.g. efficiency, appointments, salaries; as an Efficiency Audit Committee they should ensure that external audit recommendations are followed up, and more generally should act as a surrogate for absent market forces.

c. Government

6. If the relationships with nationalised industries are to improve and the difficult problems facing them are to be tackled more effectively, Government needs to have a better understanding of business. Our own belief is that in each of the main sponsor Departments there should be a separate Business Group, looking after all the Department's industries. The Business Groups need not involve any net increase in staff (unless transitionally), but should include people with business experience and relevant skills - partly recruited from outside, but increasingly the product of better, more specialised career planning. We believe that the head of the Business Group in the largest Departments should be at Second Permanent Secretary level, with the experience and status to deal direct with Chairmen; in our view he should be a senior businessman, at least

for the initial appointments while Business Groups are being established and the necessary expertise built up. This change is not intended to lead to more Government intervention in the management of each industry - on the contrary, by closer understanding it should establish a firmer strategic framework and minimise short-term crisis intervention.

7. However, it appears that Ministers and senior officials in sponsor Departments, who have the direct responsibility, are doubtful about the need for such a radical reorganisation. We remain convinced that a considerable change in organisation (more than just setting up an advisory group), and the injection of business expertise at a very senior level, are needed to bring about a substantial improvement in the relationship with industries and so in performance. If our concept of Business Groups is not favoured by Ministers collectively, we recommend that each of the main sponsor Departments should be asked to make proposals in the light of our report, within a specified time (say three months).

8. We recommend that a small Ministerial Committee should be set up, with you normally taking the chair, to consider issues of nationalised industry policy, including objectives and priorities, and to monitor overall performance against targets. It should have the support of a small Review Staff in the Cabinet Office, including people with business experience, and working closely with the Treasury. One of its first tasks could be to consider the reports on reorganisation from sponsor Departments.

Implementation

9. A full list of recommendations is at the end of the report. There has not been time to tailor these precisely to the varying circumstances of each industry. If Ministers agree with our main recommendations - clearer objectives, smaller Boards with a majority of non-executives, reorganisation of sponsor Departments on Business Group lines, and a new Ministerial Committee - the new committee could be set up at once and could supervise work on implementation, aimed at a Parliamentary statement or short White Paper before the end of the year. The changes can be implemented without legislation, except in some cases to provide in due course for smaller Boards - and perhaps as a sanction in reserve against recalcitrant industries.

10. Ministers will also wish to consider whether they want further work done on the longer-term option of regulatory agencies (paragraphs 10 and 11, and Annex E).

11. I am sending a copy of this minute and attachment to the Chancellor of the Exchequer, the Secretaries of State for Industry, Environment, Scotland, Energy, Trade and Transport, and to Sir Robert Armstrong.

JR

Att

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COPY NO: 1

THE RELATIONSHIP BETWEEN GOVERNMENT AND THE NATIONALISED INDUSTRIES

A Report by the

Central Policy Review Staff

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COPY NO 1

THE RELATIONSHIP BETWEEN GOVERNMENT AND THE NATIONALISED INDUSTRIES

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Central Policy Review Staff

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THE RELATIONSHIP BETWEEN GOVERNMENT AND NATIONALISED INDUSTRIES

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THE RELATIONSHIP BETWEEN GOVERNMENT AND NATIONALISED INDUSTRIES

A. INTRODUCTION

The CPRS was invited to review:-

- what should be the basis of the relationship between Government on the one hand and nationalised industries (and companies dependent on financial support from Government) on the other;

- how best to give effect to that relationship so as to ensure a reasonable balance between the commercial responsibilities of the Boards, and the supervisory responsibilities and financial commitments of the Government;

- the adequacy of the present arrangements for monitoring the financial performance of the industries and for giving early warning of troubles ahead.

The remit did not include consideration of either privatisation or the financing of the industries. However quickly privatisation proceeds, a number of industries will still be nationalised, anyway for years to come. So the problems of Government/industry relations will remain.

2. We have discussed these questions with Ministers concerned, with present and past nationalised industry* Chairmen and Board members, with officials at all levels in Departments and with a limited number of academics and private sector businessmen. Because of the short time for the study (2-3 months), we restricted discussions in the main to the larger public enterprises (BSC, NCB, BGC, BL, BRB, BT, Electricity Council, CEGB). However, we believe our findings and recommendations apply generally. But in implementing them it will be essential to keep in view the special features of particular industries. Because of the short time available, the CPRS has not been able to carry the discussion of all its recommendations to the point where they can be implemented at once. If Ministers endorse the principles, more detailed work will be needed in several areas.

*In this report the term 'nationalised industries' includes those companies dependent on financial support from the Government (BL, RR) as well as the statutory corporations.

B. THE PROBLEM

3. Our discussions showed that a number of problems are perceived in the present arrangements. The problem that has caused most concern recently is the poor financial performance of many of the industries. Most of the other problems are not new - they have been discussed in other major studies over the past twenty years:

(i) Lack of clear objectives. Governments have not given the industries clear objectives, and this has contributed to the need for constant detailed Government intervention. Chairmen told us that the Government had never given them a clear remit, within which they could try to run their industries efficiently. They found that priorities were often determined by short-run tactical considerations, at odds with the commercial interests and longer-term timescales of their industries. Hence common purpose is lacking, despite some good individual relationships on a personal level, and accountability is blurred.

(ii) Lack of mutual trust and understanding. Some Ministers and officials feel that they are not given full information, or early warning of potential problems, on a basis of mutual frankness and trust. On the other side the industries complain about lack of understanding and expertise within Departments. The Government sees the Boards as weak and inefficient, while the industries resent detailed intervention.

(iii) Lack of market forces. Many of the industries have monopoly power, so that financial targets cannot guarantee their efficiency. For most of them there is no realistic danger of bankruptcy, so that their managers do not have the same pressure to improve their performance as they would in the private sector. Ad hoc efficiency studies by the Monopolies and Mergers Commission (MMC), as presently constituted, are not a sufficient substitute.

(iv) Lack of motivation. From the Government's point of view there is a lack of any effective sanction against industries which fail to meet targets. Public embarrassment is effectively the only tool available, since sacking Chairmen or whole Boards would be a drastic step. On the other side the industries see themselves as subjected to public

criticism from all sides, but not often given credit publicly for their successes. Furthermore they feel that many of their difficulties arise from factors outside their control, such as the state of the economy but that Ministers and officials do not understand this properly. Chairmen feel that the climate makes it harder for them to exercise effective leadership.

(v) Extent of union power. In some industries the unions have established a dominant position, not only in pay bargaining but in wider issues affecting the industry's future.

(vi) Shocks. Ministers are concerned that a number of industries (BSC, BL and NCB) have made demands for finance substantially in excess of the levels foreseen. By the time these demands were put before Ministers, often at short notice, there was in effect no option but reluctantly to concede them.

(vii) Institutions. In our interviews we invited opinions on each of the main institutions involved - the industries, the sponsor Departments and the Treasury. Comments were almost always critical, which perhaps shows the strains in the current relationship. The industries themselves were criticised both for being too inbred and narrow in outlook, and for being too monolithic so that information and decision-making is too centralised. Being in the middle the sponsor Departments were criticised from both sides; by the industries for being ineffective in discussions with the Treasury, which made some industries want to negotiate direct; by the Treasury and others for not being tough or knowledgeable enough in negotiating with the industries. The main criticism of the Treasury was that it was financially too rigid and understood too little the effects of this on the industries.

(viii) Allocation of resources. A concern of Treasury Ministers and officials was that within Whitehall there seems no efficient system for ensuring that investment, and indeed the overall use of resources, is assessed consistently both within and between industries. Resorting to across-the-board cuts in EFLs as a method of allocating resources seems an admission of defeat in establishing priorities.

4. This summary of the problems is not exhaustive but we believe substantially covers the key perceived shortcomings in the present relationship. We shall have something to say about each of these problems and believe that our recommendations provide a sound basis for solving some and improving others. There is no perfect answer.

5. At the outset we need to distinguish between real problems and secondary symptoms. The CPRS believes that the poor performance of the nationalised industries over the past decades has five fundamental causes :-

(i) the lack of market forces and of any threat of bankruptcy;

(ii) the extent of union power;

(iii) the absence of a sufficient strategic framework;

(iv) the impact of political decisions which unavoidably clash with straightforward business objectives;

(v) a failure of communication and understanding.

6. These lie at the root of the difficulties. For instance, if union power is a problem in a particular industry it is not enough to have a close relationship between Chairman and Secretary of State, and a rational system for allocating resources or for monitoring and forewarning of problems, unless the Board and Government use their close relations to evolve a strategy for dealing with the underlying union problem. Similarly changing the administrative organisation within Whitehall will lead to nothing unless managers in the industries are motivated to behave differently; at the end of the day the Government cannot implement policy, it is in the hands of the management of the industries. Any solutions should be aimed at these basic ills.

C. BACKGROUND TO SOLUTIONS

7. Before presenting the CPRS findings and recommendations in detail there are some points to make on the background to possible solutions :-

(i) Diversity of the Nationalised Industries. The wide diversity of the industries is itself a problem - they are in widely different kinds of business, and have differing positions in the market place, from monopoly to highly competitive. This effectively excludes a single solution, but there are some general principles that can be applied, even though the industries' diversity means that great care must be taken in the application.

(ii) Previous Studies. The review covers ground that has been well ploughed before; clearly there is no philosopher's stone that will solve all the problems. The two most recent major studies - the 1968 report from the Select Committee on Nationalised Industries (SCNI) and the 1976 report by the National Economic Development Organisation (NEDO) - include much analysis and diagnosis with which the CPRS agrees. However the solutions fail to attract. More will be said about a Ministry of Nationalised Industries along the lines of the SCNI's proposal later in the paper (see paragraphs 59-62). In the view of the CPRS the NEDO proposal for a Policy Council between the Government and the Boards would in practice add another layer of control which could only further blur accountability and was rightly rejected.

(iii) Foreign Experience. In the course of this study the CPRS briefly reviewed how foreign countries tackled the similar problems posed by their nationalised industries. There are some elements of European experience that seem worth drawing on - for example the French administrative elite which forms a common culture at the top of Government, the Civil Service and industry and the French attempts to make objectives explicit through long-term contracts between the state and the industries. The US use of regulatory agencies to control the public utilities offers a different approach and is considered later (paragraphs 10 and 11). But there is clearly a limit on the extent

to which experience in one country can be applied in another country with a different cultural background.

(iv) Time Constraints. The CPRS was aware in carrying out this Review that solutions were required that could be implemented relatively quickly. Hence we have concentrated as much as possible on changes which could be made without altering the statutory framework of the industries. But however rapidly new measures are implemented, performance can only be expected to improve gradually.

(v) Underlying Problems. This slowness of response is inevitable because first people's behaviour and attitudes will have to change. Moreover, the pace of improvement will turn on the extent to which the industries continue to be affected by deep-seated and pervasive underlying problems, such as the general health of the economy and the extent of union power. The unexpected depth and nature of the 1980 recession was a major reason for the borrowing requirements of the nationalised industries increasing significantly beyond the levels foreshadowed in the Medium-Term Financial Strategy. Over the longer term too, the productivity performance of nationalised industries is likely to be affected by the general economic climate. A better relationship can help in finding ways of dealing with these difficulties, but it will not remove them.

(vi) Line Management. The success of the nationalised industries depends on their line management. The size of many of the industries in itself means that they have problems that demand high quality executive ability for their solution. On top of this there are the further complexities that arise from the interface with Government and some of them have the added dimension of having to cope with very great union power. The task of the Chairmen of the largest industries justifies obtaining the services of the most able industrialists that can be found; at present, because of the known frustrations, and indeed, the poor pay compared with the private sector, it is extremely difficult to attract such people. Any change in the relationship with Government should be aimed at clarifying, simplifying and reducing problems at the interface so that Chairmen can concentrate on running their industries.

Where additional pressures are introduced to increase emphasis on efficiency this must be done in ways which leave the Chairman and his managers unencumbered in the actual task of achieving the improvements; petty interference is extremely harmful. We believe that at all levels the quality of much of the management of the industries is good, but leadership is essential if this is to be put to good effect. The aim must be to ensure that the line management as a whole is actively pursuing the objectives that the Government desires.

D. LONGER-TERM POSSIBILITIES

Competition

8. The best way of improving the industries' industrial performance is to expose them to full competition wherever possible. All Government intervention to influence the behaviour of the State monopolies is in effect a surrogate for market forces, and a second best. How far it is possible to expose the industries, or parts of them, to increased competition needs detailed study, and was not within our terms of reference. But it is important that our proposals should help rather than hinder the process.

Privatisation

9. Where an industry can be exposed to competition, this will make privatisation easier. Again the question of privatisation was outside our terms of reference. But we have had in mind that our proposals should reinforce rather than weaken the pressures towards privatisation.

Regulation

10. Some industries, or parts of industries, have a degree of 'natural monopoly' - in the sense that, given the structure of their products and markets as public utilities, there is no efficient way of arranging for competing sources of supply. These could be returned to the private sector only if some way could be found to ensure that they would not exploit their monopoly power and push up prices to make excessive profits, or cover excessive wages and inefficiency. One answer to this would be the establishment of a regulatory agency (or agencies) to control prices, following the practice in the US referred to earlier.

11. While seeing the attractions of this in principle, the CPRS does not believe that it could offer a comprehensive solution to the problem of Government/industry relations, at least within the next few years. There would be great difficulty in giving the agency clear guidelines and defining its relationship with the Government and the Boards of the industries themselves (as well as with the MMC). It seems to us very doubtful whether the Government could lay down clear rules for determining prices, or agree to leave an independent agency with a wide measure of discretion. Without direct accountability to Government or Parliament, the agency might well ignore broader considerations

(eg energy policy) and give too much weight to special interests (eg consumers). This is discussed at greater length in Annex E. However, we have not had time to study these questions in detail, and Ministers may wish to consider whether they would like further work done to see whether regulation might be useful as a means towards privatisation in suitable industries.

E. BASIC MODEL

12. It is to the strategic management of those industries likely to remain in the public sector for the foreseeable future that the current review addresses itself. At the heart of the relationship with the nationalised industries is the need to strike a balance between the commercial aspirations of the Boards and the broader economic and social concerns that any Government is bound to have.

13. At one extreme is the traditional Morrisonian concept of an 'arm's length' relationship. This is based on the theory that once a Board has been set up, it will itself be best placed to balance the commercial concerns of the industry against the wider national interest. In practice all past experience suggests that this is unrealistic. Although the assets of the nationalised industries are vested in their Boards by statute, and the Minister's formal powers are confined to appointment of Chairmen and Board members and approval of certain key matters, the Government has a major responsibility on behalf of the public to see that they are carried on efficiently and in the public interest. Because nationalised industries play such an important part in the economy and are not fully subject to market forces, Ministers will want to intervene in areas that Boards regard as part 'management' - pay, prices, investment, efficiency - particularly when the Government's other objectives are threatened by unforeseen developments. The immediate response from the industries to Government intervention is to cry foul and argue that short-term expediency puts their longer-term objectives in jeopardy. This blurs accountability.

14. At the other extreme Ministers might take detailed powers to run the industries, almost as if they were Government Departments, for example in the way the Post Office was formerly managed. We have no doubt whatever that this is the wrong model to take. It would give Ministers a detailed responsibility which would force them to intervene in day-to-day management, and would make it impossible for managers to operate on a proper commercial footing. Any changes in working practice or reductions in manpower would risk becoming a direct confrontation between Government and the workforce.

15. The CPRS is convinced that an intermediate model is most appropriate. The Government is effectively the owner of the industry, and this entails setting objectives, pressing for efficiency improvements, monitoring performance and ensuring action to correct shortcomings. The aim must be to restrict intervention as far as possible to matters of strategic direction and performance monitoring, and to avoid management intervention of a detailed kind. We believe that the first step towards achieving this is through a much clearer definition of the objectives for each industry. Intervention should be minimised by clarifying as much as possible in advance. The CPRS solution also seeks to provide a stronger substitute for market forces by making the non-executive directors on nationalised industry Boards a more effective force, and by recommending some changes in the current arrangements for external efficiency audits.

16. If Government is to act effectively as the owner of an industry, it must be well-informed about the underlying business issues. It cannot have the same knowledge of an industry as the Chairman and senior executives, but if there is to be proper understanding and communication, and if the arguments put forward by an industry are to be effectively probed, Government must have the basic business skills. This means that each main sponsor Department needs to contain a small number of experienced businessmen of proven competence including at least one who possesses the ability to run an industry, even though it is not his immediate job to do so. Without people of this kind, however hard professional civil servants try to fill the gap, there is bound to be some lack of understanding, less than fully effective monitoring, some unreal expectations and unnecessary shocks and disappointments. To be effective this will require one businessman at a very senior level in each main sponsor Department, and several people with business skills to support him at lower levels. Clearly most of the present sponsor officials are conscientious and hard working but they need to be better prepared by means of a more specialised career progression and training.

17. Although each Secretary of State has the direct responsibility for his industries, the industries' problems impact on overall Government concerns, for example the PSBR, prices, pay and employment. There is a need for the senior Ministers directly concerned to have a structured forum in which the overall problems and performance of the industries, and financial priorities, can be reviewed. For this to be effective they need the support of a very small review staff which contains top quality business skill of the same kind needed in sponsor Departments.

18. Many of the questions about which such a Committee supported by a review staff should be concerned are at present dealt with ad hoc at short notice, and the scope for improvement is obvious. However, it will be important to ensure that all these new arrangements are confined to major strategic issues and do not develop into interference on matters which are properly the concern of Departments or the industries.

19. Although these are the basic principles of the relationship in the CPRS model, the application will be different for different industries. In principle, the need for Government attention will be less the more profitable and more exposed to market forces an industry is although some of the decisions required may still be extremely difficult. The following paragraphs set out in more detail the analysis behind, and the recommendations of, the CPRS model. They start with the need to set clear objectives for the industries, which is clearly pivotal to the relationship. Next, changes in the industries themselves are considered, and finally changes in the organisation of Government.

F. OBJECTIVES

20. At present the Government does little to set Chairmen and Boards any clear objectives. The CPRS is convinced that this explains a good deal of the resentment aroused by Government intervention, and apparent obstructiveness by some Chairmen to Government policy. Many Chairmen complained to us that they had no clear idea where in strategic terms the Minister wished the industry to go; this has been a feature common to previous studies. Although Chairmen would welcome discussions on strategy it seems that in general Ministers' diaries are too full for wide-ranging strategy discussions. Meetings between Chairmen and Ministers seem more often than not limited to discussion of one crisis or another. Chairmen would prefer to talk through such crisis issues against the backcloth of a coherent set of objectives for the industry - objectives which could for the most part remain stable for a number of years.

21. The CPRS recognises that the definition of objectives for nationalised industries is often more difficult than in the private sector, because the objectives are not solely commercial. Possibly there has also been some reluctance on the part of Ministers to commit themselves to objectives which might be political hostages to fortune. However, the CPRS is convinced that the benefits of setting clear objectives outweigh the disadvantages, and that it is essential that before appointment each Chairman should be given a clear idea of the broad objectives he is to aim for. Appointing the candidate with the best track record is not enough; indeed it can be dangerous in that, without agreed objectives, he could develop the industry in a way which conflicts with the Government's intentions. Ministers might like to ask themselves how many of the present Chairmen and Boards of the largest enterprises (NCB, BL, BSC, BGC, CEGB, BT, BR) are developing the industries in the way Ministers would ideally want? Under present arrangements Ministers have no real sanction over Chairmen once appointed, other than specific directions and ultimately dismissal.

22. The CPRS fully acknowledges that all previous major studies of the nationalised industries have argued for clearer objectives to be set, and that these recommendations have not been adopted by successive Governments. In order to give Ministers a clearer idea what is involved, we put forward in Annex A an illustration of what the objectives might look like in practice.

In general these objectives would incorporate those aims laid down by statute but would interpret these in specific business terms. Mostly the objectives would be qualitative, indicating desired trends, rather than quantitative; Corporate Plans based on the objectives would fill in the detailed figures from year to year.

23. Such a set of objectives should remain reasonably robust over a number of years and would form the basis of the partnership between the Secretary of State and Chairman. Obviously they could not remain totally immutable in a changing environment and would sometimes need updating. If either the industry or the Government wished to change the objectives, then further consultation would be necessary. This would serve to make explicit the consequences of a change in direction. Clearer objectives would also provide a better basis for judging management performance and motivating improvement. Whether such objectives were to be made public or not would be at the discretion of the Secretary of State.

24. In short, the CPRS sees four main advantages in clear objectives for each industry :-

(i) before appointment each Chairman would have agreed to the general direction in which he would develop the industry; this should improve motivation and enable management performance to be better measured;

(ii) decisions potentially at variance with the basic objectives would require renegotiation of the objectives, thus making explicit the consequences of change;

(iii) by setting the guidelines of the relationship they should help to cement a partnership between the Secretary of State and the Chairman thus avoiding the resentment at Government intervention that can arise now;

(iv) by setting objectives in strategic terms, as we propose, there should be a reduced need for Government to intervene in detailed management matters.

Corporate Plan

25. An agreed set of objectives would still mean that there was a lot of hard bargaining to be done around the Corporate Plan. However, the existence

of the objectives should mean a more structured negotiation within given guidelines.

26. The 1978 White Paper put corporate planning at the heart of the relationship between Government and the industries, and envisaged that the Government should become involved in the early stages of each plan. In the present atmosphere of distrust this does not happen. The industries produce one-future plans; officials then comment and explore the detail, but seldom elicit substantial changes. The CPRS believes that only if clear objectives are agreed can options be realistically discussed. Discussion of options will also need more business skills within Whitehall, a subject which is discussed later.

27. Out of the discussion of the Corporate Plan, the aim would be to arrive at a series of medium-term targets and budgets for the ensuing year, tough enough to set the industry a serious challenge but realistic enough for them to try to achieve. Non-commercial services undertaken at Government request would normally be identified and paid for. Financial targets, performance a i m s and EFLs would be elements in the package.

External Financing Limit

28. For as long as the Government has a central cash target in the PSBR, the CPRS sees no alternative but to monitor the industries also against cash targets, namely EFLs. However, their role needs to be clarified. If **unrealistically tight limits are set,** they will not serve to motivate management and the system will become discredited, especially if industries start to expect overruns to be topped up from a contingency reserve. The CPRS has a remit from E(NF) to examine the operation of EFLs, and the subject is best left to that report rather than pre-judging the findings here.

Monitoring

29. Clearly once targets have been set progress towards them must be monitored. We have examined **some of the systems now used to** monitor industries' performance; as a cross-check we have also looked at the systems employed by large private sector companies with diversified holdings. We believe that the system for the nationalised industries could be improved to help with the strategic management of the industries.

A summary of our general proposals is at Annex D. A fuller account will be prepared, with some suggestions for individual industries, and will be made available to officials. It is important to underline that these proposed improvements in monitoring should not impose further burdens on the industries; if their internal management systems are adequate the industries will already have all the data needed.

30. The combination of an improved monitoring system associated with our proposals to introduce more business expertise into Whitehall should lead to better supervision of the industries. Given early warning of potential shortfalls against target, which the new monitoring proposals will provide, it is essential that remedial action is subsequently taken by the industry. Greater business expertise should give Whitehall the ability to distinguish with confidence to what extent any potential shortfall against target is due to factors outside the industry's control. It should also give Whitehall a better understanding of what the commercial consequences of the various remedial options might be and in turn, through development of a common culture with the industries, help Government to persuade management of the appropriate level of response. It is important to emphasise that the system proposed does not mean that Government will be taking management's decisions for them; but rather that unless Government has the necessary business skills it will not be able to judge whether the level of response that the industries are proposing is adequate.

G. THE INDUSTRIES

Overall Structure

31. The sheer size of some of the industries makes them difficult to manage effectively. Many are too monolithic and in appropriate cases need breaking up into more manageable units. Besides leading to direct efficiency gains this could serve to make policy issues more explicit, for instance by exposing cross subsidies. In general, one would like to see sub-units of the industries producing accounts which relate profits to use of assets wherever this seems sensible.

32. There is a particular structural problem for the Electricity Supply Industry in England and Wales. The unwieldy Electricity Council is at present required to meet an EFL without any authority over the area boards and CEGB. In the view of the CPRS this system is unworkable. Progress towards efficiency improvement must start with a change in the present set-up. We recognise that the Department of Energy is considering how the system can be changed and we recommend that they should bring forward proposals as soon as possible.

Board Structure

33. The statutes for the nationalised industries have very little to say on the structure of the boards other than prescribing their minimum and maximum overall size. In many of the public enterprises executive directors outnumber the non-executive directors, a structure presumably modelled on the private sector; however, the CPRS firmly believes that in the nationalised industries a majority of non-executive directors is preferable. In the private sector market disciplines ensure that the executive directors are constantly under pressure to improve performance. In the absence of the threat of bankruptcy in public enterprises executive directors and managers below them are not under the same pressures. The CPRS would like to see on Nationalised Industry Boards a majority of non-executive directors to act as a surrogate for these pressures for greater efficiency in the use of resources and to stop the executives on the board becoming complacent. It seems to the CPRS that non-executive directors stand the best chance to become an effective force if they outnumber the executives; in any event there need to be enough non-executives to be mutually supportive.

But a majority in itself is not enough. They need to be people with sufficient experience, confidence and willingness to press the executive directors effectively to take action on efficiency questions; mostly they should be recruited from those with management experience in large private sector organisations. We have found evidence that many of the present non-executive directors do not exhibit the qualities we describe above.

34. However, such a structure would be ineffective unless the non-executive directors were informed clearly by the Secretary of State of the role they were to fulfil. We do not believe that in the past enough care has been taken to give them a clear indication of what was expected of them. In addition to their general responsibilities determined by statutes, the CPRS believes that the non-executive directors should be charged with certain specific tasks by the Secretary of State. Among these would be:-

(i) to ensure that the industry's objectives are adhered to, but if change becomes necessary that this is negotiated and agreed;

(ii) through the mechanism of a Board Efficiency Audit Committee (see paragraph 36 below)

(a) to take a special interest in the internal efficiency of the industry and ensuring that best management practice is brought in, and

(b) to ensure that external efficiency audits of the type undertaken by the MMC are followed up, ie that management takes the necessary action;

(iii) advising on appointments both executive and non-executive through a Board Appointments Committee (with the Secretary of State of course retaining the ultimate authority for appointments);

(iv) advising on board salaries (once again subject to the Secretary of State's ultimate authority).

35. It is envisaged that the non-executives accompanied by the Chairman would have an annual meeting with the Secretary of State to report on progress towards these specific objectives. Among benefits from such a meeting could be to highlight opportunities for privatisation of subsidiaries or potential joint ventures with the private sector. The meeting would also provide an opportunity to review the relationship with the Department and for the Chairman, supported by his non-executive colleagues, to comment on whether interventions had been constructive and had concentrated on major issues.

36. On efficiency, whilst external audits have a role to play in identifying areas which the Board may have missed, the Board alone has the collective responsibility for efficiency and only it can see clearly the practical obstacles. The CPRS believes that only an effective number of non-executive directors on the Board can combine the general business experience with the opportunity to press the executives towards greater efficiency, for which the Board as a whole carries responsibility. It would not be appropriate for a sponsor Department to attempt to fulfil such a role through external interference. The non-executive directors should constitute an Efficiency Audit Committee. This Committee should press the line management to produce evidence of improvement on all major efficiency issues. In some cases it might be appropriate for one or two high-potential young managers from within the industry to participate in efficiency studies; they would provide the detailed knowledge of the operations in an analogous way to Rayner scrutinies. This in turn would help to inculcate a sense of efficiency within the organisation when these managers return to line management positions. The Efficiency Audit Committee could also press for consultants to be engaged as it saw fit.

37. The CPRS is in principle in favour of small Boards of Directors (7-10 members). The larger the Board, the less the opportunity for constructive discussion and the more the key decision-making devolves to some small group. There are strong arguments therefore for small cohesive Boards on the BL model (three executive, four non-executive members). Clearly a move towards smaller Boards for the public trading sector would ease one of the difficulties in having non-executive directors in the majority on public enterprise Boards, namely the recruitment of sufficient non-executive directors of high enough quality. The usual counter-argument to having a smaller Board is that by restricting the number of executive positions on the Board the motivation of management will be reduced, since a position on the Board is naturally regarded as the pinnacle of a career. However, experience in the US, where in general there are very few executive positions on Boards, seems to undermine this line of argument.

38. If Ministers endorse the general principle of smaller Boards with a majority of non-executive directors, there will be a difficult transitional phase in moving from the current situation. It will not be sufficient to rely on natural wastage. Annex B discusses this further and shows the current membership of the nationalised industry Boards. Only in a small number of cases is the statutory minimum size of the Board at variance with the CPRS recommendations - see Annex B.

Civil Servants on Boards

39. In the context of Board structure, the CPRS has considered the case for having civil servants as non-executive directors on nationalised industry Boards. The general argument in favour is that such arrangements improve mutual understanding between Whitehall and the industries. While not wishing to rule out the possibility in every case, the CPRS is in principle against the concept of civil servants as board members. Having civil servants on the Board can lead to conflicts of loyalty and interfere with the coherence of the Board, which must at the end of the day be collectively responsible for decision-taking. Giving the non-executives a clear task on efficiency will itself put a strain on Board cohesion, but one which ultimate collective responsibility should be able to withstand. However, further pressures should be avoided. Once Board cohesion is broken, strategic decision-making tends to be driven away from the Board to the executive. One advantage claimed for giving civil servants seats on Boards, that it improves their knowledge of the industry, should be secured by our proposals for sponsor Departments (paragraphs 65-76).

Outside Recruitment of Senior Executives

40. Some of the industries (CEGB, BGC, NCB and BT seem prime examples) show classic symptoms of being too inward-looking and inbred. In these industries the CPRS would see some scope to reinforce non-executive directors by appointment of a few outside senior executives in preference to internal candidates. Suitable candidates could be found from people who had previously left the industry to widen their experience. In any event they must be knowledgeable and have relevant skills if they are to have an impact. As another counter to inbreeding executive directors on nationalised industry Boards should be encouraged to take up non-executive directorships in the private sector in order to widen their horizons.

External Efficiency Audits

41. The CPRS believes that external efficiency audits have a vital part to play in complementing the role of non-executive directors in a sustained drive for efficiency in those industries that do not face competition. We consider that some of the references carried out by the Monopolies and Mergers Commission under Section 10 of the Competition Act demonstrate that audits on these lines can be useful. However, implementation rather than recommendations is the real test of the effectiveness of such references. The CPRS believes that more should be done to ensure that recommendations are followed up. We also think that regular audits of a particular industry are necessary in order that the external audit team can become progressively more knowledgeable and therefore incisive.

42. The CPRS recommends that each nationalised industry that is not operating in a fully competitive market should be subject to an external efficiency audit on a regular basis, say every four years, or more frequently if the audit shows this to be needed. The aim will be to form an independent view of the industry's performance, and this will serve two purposes :-

(i) to report on the extent that any findings in previous audits have been followed up;

(ii) to complement the efforts of non-executive directors by opening up the industry for external scrutiny in depth every few years to examine the changing situation and scope for improvements.

We suggest that it should be normal practice before an audit begins, for the sponsor Department to tell the external audit team where they suspect areas of inefficiency.

43. The MMC itself need not have a monopoly of external efficiency auditing of the nationalised industries. It is the body immediately available, and therefore the obvious one to use at present. However, if Ministers decide to explore further the possibility of adopting a regulatory system (see paragraphs 10-11) the best way of ensuring effective and penetrating efficiency audits merits further study.

44. Furthermore some criticisms of the MMC's style of reporting have been brought to our attention. With the exception of their findings against the public interest the MMC give no sense of priorities in their recommendations. Nor do they attempt to quantify potential savings or make proposals for implementation which would allow progress to be monitored. By contrast we were favourably impressed by the approach of one of the management consultancy firms concerned with auditing the efficiency of public utilities in the USA. It appears to operate on a less adversarial basis vis-a-vis management and thereby secures the co-operation and commitment of management to implementing efficiency measures. It may be that the MMC's approach is conditioned by the statutory nature of its references. **Therefore** we recommend that in the more extended programme of efficiency auditing which we propose the opportunity should be taken of allowing such management consultant firms to show what they can do. In this way it will be possible to complement the obvious strength of the MMC with some of the techniques developed by these consultants.

45. We recommend that following external efficiency audit findings the Efficiency Audit Committee on the Board be charged with ensuring that the management has an effective quantified plan for implementing the recommendations. It should also be the responsibility of the Efficiency Audit Committee to check that the savings are achieved.

Chairmen

46. The nationalised industries pose very difficult management problems. The largest are complicated enterprises, comparable in size and complexity with the biggest private sector companies. They often have trade union problems which are greater than any in the private sector, and management is carried out under the constant glare of public scrutiny. The Chairmen are by private sector standards badly paid. It is therefore important to keep in mind the factors motivating them, and to support them in the job they are doing.

47. The appointment of the right Chairmen to head public enterprises is obviously crucial. The Chairman is the person who is ultimately responsible for the industry, represents it in public, provides the qualities of leadership, forms the main channel of communication with Ministers, and appears before select committees. To do this effectively for a large complex industry means he must

be deeply immersed in the industry and therefore, it seems to the CPRS, must necessarily be a full-time appointment. But in smaller and simpler industries, where the demands of the Chairmanship are not so severe, there is much to be said for a part-time appointment.

48. In order to attract and retain a person of the necessary calibre it will be necessary not only to offer a suitable salary but also to assure him that Government will refrain from detailed interference.

49. A possible method of motivating Chairmen given clearly agreed objectives is payment partially by results, along the lines of the payments to Lazard Freres in respect of Mr MacGregor. This could also be useful presentationally when the Government is trying to restrict pay increases generally and tie them to increases in productivity.

50. Especially in situations where a Government wants radical change in an industry, it is important that although deeply knowledgeable about the industry the Chairman should not be captured by it. He must retain his objectivity, and not obstinately defend the industry against all change. He must be capable of appreciating the wider scene in dialogue with Government. Such a balance will be made easier if the Chairmanship is kept separate from the Chief Executive appointment in those industries where there is a substantial industry-wide executive job to be done. This will prevent the Chairman being swamped by detailed management issues. Equally it would help if the Chairman is an outsider, though given the size and complexity of the larger industries he would require some experience of the industry if he is not to be out of his depth. Most important of all, however, the danger of lack of balance would be averted if, before appointment, the Chairman is given a clear indication of the direction in which the Government wants the industry to move, in a set of clear objectives.

Leadership

51. In the course of our interviews many Chairmen pointed to the harmful effect that public criticism of the industries by the Government was having on the morale of staff. Clearly the nationalised industries have many defects, but they also have some good points. The CPRS believes that from time to time the good points could be highlighted and credit given where due; if done properly this could improve motivation across the public trading sector.

52. Another matter raised by Chairmen was frequent delay in making appointments or re-appointments at Board level. It was very unsettling and disruptive for the individual and the Board if re-appointments were left to the last minute. The CPRS did not investigate the circumstances surrounding individual cases, but it is obviously a principle of sound management to try to reduce uncertainty in the matter of appointments or re-appointments and to settle them as expeditiously as possible. This means that succession planning must be carried out well in advance, and the CPRS believes the non-executive directors have a role to play here.

Union Power

53. Enlightened leadership and close relations with Government are particularly important in those industries with problems of monopoly union power. It would be wrong for Government to interfere directly on these problems. This is largely a matter for the Boards and management of the industries. We believe that there is much scope in most of the industries for improvements in productivity and for tougher pay bargaining. But this must largely be achieved by skilled and determined efforts by the Boards and their management. And success probably depends upon steady progress over a number of years. In attempting these measures the Boards are likely to face considerable difficulties from their workforce, from their customers and from the media. The CPRS believes that the Boards will need the support and encouragement of Government if they are to strive successfully. And Government will wish to ensure that the Boards are trying hard. We believe that the sense of a businesslike partnership between Boards and Government will help considerably to create a better environment for tackling these problems and will stiffen the Boards' resolve. Putting it the other way round, a Board which feels that the Government does not understand its problems and continually denigrates it may not be strongly motivated to try. The damage that can be done by strong monopoly unions against timid management need not be recounted here.

H. GOVERNMENT

54. The relationship between Government and the nationalised industries is a multi-faceted one. We believe that it has at least six aspects:-

(i) The Government has to represent the interests of the public as shareholder - the 'owner' function;

(ii) The Government is also responsible in a broad sense for the interests of the public as customers of the industries;

(iii) The Government is banker to the industries;

(iv) It is also responsible, as Government, for the role of the industries in the economy;

(v) The Government has social objectives that impact on the industries, eg to retain a 'non-commercial' railway;

(vi) The Government is concerned with the role of the industries within wider policy objectives eg BGC within energy policy.

55. The third and fourth roles, banker and macro-economic interest, naturally and inevitably reside in the Treasury; the other roles reside largely, but not exclusively, in the sponsor Departments, who are also required to act as intermediaries between the industries and the Treasury. In drawing up clear objectives it will be necessary to comb through these different roles to ensure that each is adequately represented and potential conflicts are resolved.

56. Thus sponsor Departments are responsible for most aspects of the relationship between Government and the nationalised industries. They hold the key to improving it. We have to say that our discussions with Chairmen and others showed dissatisfaction with the performance of sponsor Departments beyond what might naturally be expected. It would be invidious to pick out detailed examples, but as a result of those discussions we are convinced that a radical improvement in their ability to supervise the industries is needed, in a number of respects:-

(i) more business expertise to understand in detail the commercial problems facing the industries and the business implications of political decisions;

(ii) more intensive effort to extract relevant information from the industries (including options when major policy issues are put forward, eg at IFRs);

(iii) more skilful monitoring of performance, so as to be able to give clear warnings to Ministers and the Treasury when there is a risk of an industry going off course;

(iv) better relations with the industries at all levels, including Chairmen and non-executive Board members, based on better understanding and clearer statements of objectives;

(v) stronger pressures for efficiency.

57. Sponsor Departments face a wide range of problems with their industries, and tackle their responsibilities in various ways. Officials are obviously well qualified to support Ministers on the more political aspects of their work but they are less well equipped on the more commercial aspects. Furthermore few Ministers have first hand experience of running very large industrial organisations. In our view the basic difficulty facing sponsor Departments is insufficient understanding of the industries as businesses. If there is to be proper understanding and communication between Government and the industries and if the arguments put forward by an industry are to be probed effectively, sponsor Departments must be able to equal the basic skills of the management. Without business experience in the sponsor Department, there is bound to be some lack of understanding, less than fully effective monitoring, unreal expectations and unnecessary shocks and disappointments. The Treasury finds difficulty in co-ordinating while information and effectiveness within Departments are so varied. When the Treasury's confidence in the effectiveness of a particular sponsor Department is undermined, it tries itself to fulfil the role without the knowledge, expertise and time. The result is that some industries are left wondering what role the sponsor Departments play.

58. We have started from the position that a fundamental institutional change is needed to achieve the necessary improvement in performance. Previous suggestions for making sponsor Departments more effective in their ownership function, while keeping their present organisation, have come to nothing.

Ministry of Nationalised Industries

59. The first and most radical option considered by the CPRS is a Ministry of Nationalised Industries. Nationalised industry policy would be concentrated within a single new Ministry while the Treasury fulfilled its traditional roles as banker and macro-economic guardian; other Departments would be concerned with sectoral or social objectives, and would negotiate these with the central Ministry. The concept has immediate attractions. It would concentrate the expertise to be found within the present sponsor Departments, and build on it so that the Ministry should quickly become an expert body. The Ministry could be granted an aggregate EFL by the Treasury for all nationalised industries, and could recommend for collective approval by Ministers an allocation of resources on the basis of its well-informed assessment of priorities. A single body should ensure consistency of approach. Moreover, it would allow Ministers of the present sponsor Departments to represent the interests of the private sector while a separate Minister argued the case for the public enterprises; these interests now have to be reconciled within each Department.

60. However, in the view of the CPRS the concept has drawbacks, which outweigh the advantages, at least in the short term. Perhaps most important for Ministers is the delay before it could come about and the upheaval required within Whitehall at just the time when the Government's MTFS is going through its most crucial phase. Effort would be diverted at the moment when control should be at its most effective. Furthermore the CPRS is convinced that until business experience is built up, it would be impossible to move to a Ministry of Nationalised Industries without a high probability of failure.

61. A Ministry of Nationalised Industries would indeed be a super Ministry, responsible for enterprises that generate around 10% of GDP and invest an amount annually of the same order as the whole of private sector manufacturing. It must be doubtful whether the Secretary of State heading up the Ministry could cope with the diversity of problems presented by all the state enterprises.

62. It may be that further examination could find ways of overcoming these problems, and that the Ministry of Nationalised Industries will prove to be the most effective long-term solution. However, given the constraints and the need for a quick solution, the CPRS did not pursue this option further. The CPRS proposal for introducing more business experience in the existing structure is consistent with, and indeed we would argue a necessary precursor to, moving to a Ministry of Nationalised Industries at a later date.

Expanded Treasury

63. Another possible solution is to integrate the ownership role within an expanded Treasury. The arguments on overall size and the prior need for business skills apply again. In particular, the possible overload on a single Minister responsible for the nationalised industries, referred to in discussing the Ministry of Nationalised Industries, would be even more serious for the Chancellor with his current heavy responsibilities. Even aside from these points, could the Treasury combine and reconcile the functions of owner, banker and overall responsibility for the industries in the economy? In the view of the CPRS this must be seriously doubted. There is a risk that undue weight would be given to short-term financial considerations, rather than commercial efficiency. There is also a risk that the interests of nationalised industries would not be effectively defended against the competing demands of other public expenditure programmes from spending Departments. The present system does at least mean that the nationalised industries have powerful spokesmen in Cabinet when their claims come to be balanced against those of other expenditure, such as social security, defence etc.

CPRS Proposal

64. We have concluded that the only solution that is practical in the short term is:-

(i) to modify the sponsor Departments and increase their business expertise so that they will be able to fulfil their role more effectively;

(ii) to establish a powerful Ministerial steering group for Nationalised Industries supported by a review staff with a business analytic orientation.

Modified Sponsor Departments

65. The proposal we favour is to set up, in each of the three major sponsoring Departments (Industry, Energy and Transport) a single separate sector of the Department - the Business Group - concerned with the industries as businesses, and exercising this function for the Department's portfolio of nationalised industries. The Business Group would be small but staffed with able people including some with business experience. The Business Group would undertake most of the Department's direct dealings with its nationalised industries.

Sectoral and other issues that did not exclusively affect the nationalised industries would be administered by officials in other parts of the Department; when such issues impinged on the nationalised industries these officials would of course consult the Business Group.

66. The advantage of separating the business from other interests is that it would allow the Business Group to develop expertise, and to gain understanding in depth of the industries, so that relations with the industries could develop on a more equal footing. With people who had a deep understanding of how an industry works it would be easier on any issue to form a judgement on how the proposal would affect its commercial interests, and to ensure that Government is explicit about, and calculates the cost of, pursuing non-commercial objectives. Once the different objectives had been resolved and balanced within Whitehall the Business Group would be the prime channel of communication with the industry. The nationalised industries would thus have to deal with a commercially-minded arm of Government which would support the Secretary of State by negotiating clear, tough, but realistic, targets with the industries. This should provide a good environment for the industries to improve their performance; moreover it would clarify accountability and remove the scope for excuses for failure.

67. An important feature of the Business Group is that it would deal with all the industries sponsored by a Department. This should promote a more consistent approach to the industries within the Department's portfolio, so that priorities between them could be set rationally. It should also help to prevent officials being captured by a single industry and accepting its views uncritically.

68. The main job of the Business Group would be to establish the necessary partnership with its industries. Its first task would be defining the objectives for the industry and getting them accepted. Thereafter its main emphasis would be on the Corporate Plan, which establishes the speed with which objectives are to be achieved, and financial targets. Non-commercial services undertaken at Government request would normally be identified and paid for. Performance indicators would be set and progress monitored. The relationship would vary somewhat for different industries, but these are the essentials. We do <u>not</u> envisage the Business Groups indulging in **'second-guessing'** of the industries' management, ie conducting elaborate studies to check management's own analysis. Rather we see the Business Groups knowing what <u>questions</u> to ask

the industries, judging whether the answers are adequate, and probing when they are not. This is the kind of role that a private sector holding company plays in relation to its subsidiaries. The role and staffing of the Business Groups is described in more detail in Annex C.

69. Many previous studies have identified the lack of expertise in Whitehall to fulfil such a role; there is very little direct business experience amongst civil servants. It seems to the CPRS that a necessary pre-requisite for breaking down the barriers towards a greater partnership is a greater understanding within Government of business. Opportunities certainly exist for achieving this :-

- more secondments to and from nationalised industries (as well as the private sector);
- more employment of people with business skills and experience, either on secondment or permanently;
- more training eg Business Schools with relevant courses on management, accounting, and other numerate skills;
- secondments between departmental Business Groups;
- secondments to the review staff of the Ministerial Committee.

70. A common long-standing complaint voiced by the industries is that people move too frequently within the sponsor Departments. In the industries' view it takes two to three years for someone in the sponsor Department to become properly informed on the industry and its problems, and this is comparable with the expected lifetime in the appointment. The industries themselves therefore waste undue time educating sponsor Departments. It is also said that personnel moves within sponsor Departments seem not to be co-ordinated. For instance, last year in the case of both BL and BSC there were almost simultaneous changes in the appointments at Deputy Secretary, Under-Secretary and Assistant Secretary level.

On coal, in the middle of the current complicated negotiations with NCB, there has been a simultaneous change at both Deputy Secretary and Under-Secretary levels. Such wholesale changes tend to undermine the relationship with Government in the eyes of the industries.

71. In order to enhance expertise within Whitehall, and to meet the points of criticism in the last paragraph, the CPRS would recommend that for civil servants in the Business Groups there would be a career structure that enabled them to spend much of their careers in dealing with the nationalised industries so that they built up the special expertise needed. They would generally stay longer in each post. Such people would be identified early and have their career path structured accordingly, including the development opportunities identified in paragraph 69. Their knowledge of business would be useful also to the rest of the Department in its dealings with the private sector.

72. The CPRS believes that the head of the Business Group, in particular for the larger Energy and Industry portfolios, should have wide business experience with the rank of Second Permanent Secretary, for the following reasons:-

(i) the Chairmen of the nationalised industries wish to talk on an equal footing and this requires someone of the highest standing in the business world, who could only be recruited to a very senior rank in the Civil Service;

(ii) the head of the Business Group would have the task of ensuring that the conflicts between commercial and political objectives, which cannot be entirely avoided, are resolved within Government on a proper understanding of the facts and arguments, rather than at the interface with the industries. To do this effectively he would need the standing we propose;

(iii) the head of the Business Group would have an influential role in finding non-executive directors of sufficient quality to serve on nationalised industry Boards; to do this effectively he would need to have sufficient status to talk informally with private sector Chairmen about particular individuals;

(iv) there is a danger that the Business Group would not become an effective force without strong and powerful leadership at the top;

(v) for Business Groups to offer attractive careers to able civil servants, it would need to be clear that this did not impair their chances of reaching a very senior level in the Civil Service.

73. It is envisaged that initially the Second Permanent Secretary would be an outsider, perhaps nearing the end of a successful career in business, as only such a candidate would have the experience and status we see as necessary. Clearly an outsider would have m u c h to learn about Ministerial and inter-departmental processes of decision-making; but we consider that for this post such experience is less essential than business expertise. However, as time goes on, with career structures more directed towards business, there would be an increasing likelihood that an internal candidate would be suitable. The Permanent Secretary would remain in overall charge of the Department's management and use of resources, and broader issues of sectoral policy.

74. The CPRS considers that these proposals for Business Groups are the minimum change needed if the Government is to be effective in its relations with nationalised industries. But we have to say that in our discussions with Ministers and senior officials in sponsor Departments, it has become clear that the Business Group concept does not commend itself to them. They argue that most of the problems with the nationalised industries are political rather than commercial and that there is value in the links between nationalised industry and sectoral work which Business Groups would lose. In particular it has been put to us that the presence of senior experienced businessmen in a sponsor Department would not be welcomed by the industries - Chairmen would not wish to be supervised by another businessman. Initially such feelings might arise for in some respects insufficient business experience in sponsor Departments gives industries an easy ride at present. But a suitable senior businessman in a sponsor Department should quickly be able to establish a good relationship based on mutual respect, and be able to remove the lack of understanding of their problems which the Chairmen now find frustrating. It has also been put to us that a senior businessman would impede the direct contact between Secretary of State and Chairmen (cf NEB's relations with BL and RR). But in our view there is little substance in this argument when the head of the Business Group (unlike NEB) would be reporting direct to the Secretary of State.

75. We believe that the other arguments could be met within the structure we envisage. We emphasise our conviction that there is no prospect of improving the relationship between the Government and the nationalised industries without a radical shift in the sponsor Departments towards a more commercially-minded approach. In our judgement this will not happen without changing the structure of the Departments, to mark the change in approach and put business expertise in a position to make a real difference. Merely to provide more business training or bring in a few people with business experience to form an advisory group would not be enough.

76. However, the CPRS must recognise that Ministers and senior officials in the sponsor Departments are in a strong position to judge what changes in management and organisation are needed, in the particular circumstances of their Departments, to implement this new approach. If after collective discussion our Business Group proposal still does not find favour, we suggest that each of the main sponsor Departments should be asked to review its organisation, taking account of our Business Group proposals, and to make its own proposals for securing the radical improvements in performance listed in paragraph 56 above, in a report to the Ministerial Committee (see below) within a specified time. Before leaving this section of our report we must emphasise that successful direction and supervision of businesses requires business knowledge. For very large complex industries the Chairmen, as mentioned elsewhere in this report, should be business executives of the highest quality. But comparable basic skill is needed within Government if they are effectively to be given the required broad strategic direction on a basis of mutual confidence. This is a problem of people not just/organisation. The improvements needed will not occur unless a few people of the right quality and experience play a leading role in sponsor Departments.

Ministerial Committee

77. The CPRS recognises that it is recommending a major cultural change, and to ensure that it takes place there needs to be some force in the centre, in addition to the Treasury, to guarantee that the Business Groups fulfil the role envisaged. There are also practical operating functions. For this purpose the CPRS recommends a small Ministerial committee. Because of the importance of the issues likely to arise and their impact on overall Government policy, the committee should be chaired by the Prime Minister, although to relieve the

pressure on her the Chancellor could sometimes deputise; in addition it would include Treasury and sponsor Ministers. The committee would become the normal Ministerial forum for collective discussion of the affairs of the nationalised industries. The following roles are envisaged for the committee:-

(i) if Ministers accept our main recommendations about setting clear objectives for the public enterprises, there is going to be a difficult process of transition. During this process the Ministerial committee needs to check that the objectives being developed for different industries are consistent with each other and with the Government's wider medium-term objectives;

(ii) the Ministerial committee would be the principal forum for sorting out priorities across the industries. It would also be responsible for ensuring that there was a consistent approach to the industries on such matters as investment appraisal;

(iii) the committee would also monitor the industries' overall performance against budget throughout the year. The Quarterly Monitoring Report currently discussed at E(NF) would form the basis for this. At the last E(NF) meeting it was agreed that the industries must be asked in advance for a quarterly breakdown of their expected performance for any given year. This will make monitoring much more effective, since it is only by comparing performance to date against budget that prospects for the year's outturn can be sensibly discussed. Together with our detailed proposals for monitoring in Annex D this should reduce the likelihood of surprises or shocks from the industries, although because of the sudden emergence of external factors it cannot eliminate them;

(iv) the committee would also consider questions of general industry policy:-

- privatisation, competition, liberalisation
- methods of financing
- pay
- prices (of the monopolies);

(v) the committee would also be available as a forum for discussion if Treasury and sponsor Department Ministers could not settle differences of opinion at a bilateral meeting.

It would be important that the committee should not become involved in those issues which ought to be settled by individual Departments and that, like Departments, it should resist the temptation to intervene in the affairs of industries on matters other than those of strategic importance.

Review Staff for Ministerial Committee

78. It follows from the nature of the functions suggested above that the Review Staff for the committee would need to have a probing, analytic, business-oriented role. It would ensure that Ministers address the right issues, are adequately forewarned of impending problems, and are supported with expert advice. It would be small and make recommendations on policy issues including priorities, and would carry out special studies. It would need to include people w i t h business experience. We favour locating it in the Cabinet Office rather than the Treasury. This would establish its neutrality between Treasury and Business Groups, so that the Business Groups should be more willing to co-operate with it and give it information than sponsor Departments are with the Treasury now. Equally it would not be subject to the same short-term public expenditure pressures that inevitably arise in the Treasury. One possibility might be for the Review Staff to be located initially within the CPRS while the new system is being set up. The Review Staff would exist only to service the Ministerial committee. It would restrict its attention to matters that were the proper concern of that committee; it would consciously avoid trying to become an additional layer in the machinery for controlling the nationalised industries.

79. The Review Staff would clearly need to work very closely with the Treasury, particularly on financial performance and investment review. In view of this the CPRS recommends that the secretaries for the committee should be provided jointly by the Review Staff and the Treasury.

Manpower Implications

80. The CPRS believes that the re-organisation into Business Groups and Review Staff can be brought about by redeployment without any overall increase in manpower except that there might be a small increase in the first few years as

business expertise is introduced into the Business Groups by secondments from outside. This is discussed in more detail in Annex C. But the CPRS cannot comment in detail on individual Departments. If Ministers accept the CPRS recommendations it will be the responsibility of individual Departments to advise how the principles could be applied in specific instances.

Treasury

81. The above proposals will leave the Treasury role unchanged in theory but different in practice. The CPRS believes that the Treasury divisions dealing with nationalised industries are at present significantly overworked. From what Treasury officials have told us it seems that this results partly from lack of expertise in some parts of the sponsor Departments; this should be rectified by our proposal for Business Groups and the Review Staff serving the Ministerial committee.

I. MINIMUM REQUIREMENT FOR CHANGE

82. The CPRS proposals, in particular on clearer objectives and more expertise within Whitehall, are aimed at making the present system work effectively, not a major reform. Because of this, the proposals should be capable of implementation without statutory changes. But at some stage there could be a need for legislation, if some of the industries resist necessary changes which are in line with the Government's objectives, or refuse to provide information. However, the CPRS believes that it will be a sign of the success of the new arrangements if such problems can be overcome by persuasion rather than legislation. It may also be necessary to legislate for changes in nationalised industry Board size and structure in a limited number of cases. Our recommendations for institutional change within Whitehall do not involve changing the established relationship of the industries with either sponsor Ministers or Parliament.

83. Re-organisations are necessary to make people behave differently, but they are not sufficient in themselves. In order to change behaviour there has to be a change in pressures. Implementation will need a push by Ministers and a willingness to accept change by the sponsor Departments. What then are the minimum mutually supporting requirements in order to achieve the improved relationships we are seeking? In the view of the CPRS these are fivefold:-

(i) clear objectives must be set for each industry;

(ii) the sponsor Departments must become more business oriented; our preference is for Business Groups headed by senior experienced businessmen with the rank of Second Permanent Secretary;

(iii) the Ministerial committee, as well as dealing with policy issues, must review progress on implementing the change and must closely monitor progress to ensure that each party is fulfilling its new role;

(iv) within the industries the Chairmen must be of the right calibre, and must fully accept the objectives;

(v) the non-executive directors must be of high quality and be given precise tasks to fulfil.

J. Summary of Recommendations

84. The full list of our recommendations appears below; the numbers in brackets indicate the paragraphs where the recommendations appear in the report :

1. Government to set clear objectives (20-24) to be quantified through the Corporate Plan and annual budget (25-27).

2. Government to monitor performance against objectives employing an improved information system (29-30) similar to those used by large private sector companies.

3. Boards of the more 'monolithic' industries to try, as far as sensible, to break up the structure into smaller profit centres (31).

4. Reorganisation of the Electricity Supply Industry to be considered (32).

5. Boards to be restructured so as to be smaller (37) and to contain a majority of non-executive directors (33) but, in normal cases, not including civil servants (39).

6. Responsibilities of non-executive directors to be set out by the Secretary of State (34) and to include the operation of an Efficiency Audit Committee (36) and advising on Board appointments and salaries (34).

7. A few senior executive positions in certain industries to be filled if possible by outside appointment (40).

8. Executive directors to be encouraged to take non-executive directorships in the private sector (40).

9. Industries not fully exposed to competition to be subject to regular external efficiency audits (41),

to be carried out for the time being by the MMC and management consultants (44), with an emphasis on proposals for implementation (41 and 44) on which the Efficiency Audit Committee of the Board can check that appropriate executive action is taken (45).

10. In the longer term, particularly if Ministers decide to explore the possibilities for independent regulation, the arrangements for efficiency auditing to be subjected to a fundamental review (43).

11. The Chairman of the Board, where possible, to be separate from the chief executive (50), and, in some of the smaller and simpler industries, to be a part-time appointment (47).

12. The Secretary of State to obtain acceptance from the Chairman, before appointment, of the strategic objectives for the industry (50) but to refrain from detailed interference (48); the possibility of linking Chairman's pay to the performance of the industry to be considered (49).

13. Government to encourage Boards by praising good performance (51) and by planning appointments and re-appointments earlier (52), and to support the Boards closely in their efforts to deal with problems of union power (53).

14. Each of the main sponsor Departments to set up a Business Group (65-68), to be staffed by officials with a more specialised career progression (71) plus a few secondments from the business world (69), such staff to spend longer in each post than at present (70) and to be led by a second Permanent Secretary (72) who, in the first instance, would be a senior and respected businessman (73); the precise form of the Business Group to be designed by each sponsor Department in the light of its particular requirements.

15. If recommendation 14 does not find favour with Ministers collectively, then each of the main sponsor Departments to be asked to review its internal organisation for supervising its industries and to report back to the Ministerial Committee within a specified time with firm proposals (76); this review to consider effective means for bringing more business expertise into the Department's dealings with industries, for establishing clearer objectives, for better analysis of strategic options, for more skilful monitoring of performance and for exerting stronger pressure for efficiency (56); the review to take account of the CPRS suggestions about Business Groups.

16. A Ministerial Committee to be formed to oversee policy for Nationalised Industries (77).

17. The Committee to be supported by a small Review Staff with business expertise based in the Cabinet Office (78) and the secretaries to be provided jointly by the Review Staff and the Treasury (79).

ANNEX A

OBJECTIVES FOR NATIONALISED INDUSTRIES

As explained in paragraphs 20 to 29 of the main paper the CPRS believes that a satisfactory relationship between Government and Nationalised Industries can only be achieved if clear objectives are set out for the latter and agreed by both parties. As an indication of the types of objective we have in mind we list below a purely illustrative set of possible objectives for British Telecom (BT). We have selected BT because:-

- it has, till now, been a monopoly and so provides an illustration of the need for the objectives of monopoly industries to compensate for the lack of market forces;

- it is an industry which the CPRS has studied recently;

- it provides an illustration of some of the issues that arise when steps are taken to introduce competition and to privatise some or all of an industry.

2. We recognise that the setting of clear objectives raises difficult issues; indeed one of the main reasons for establishing such objectives is to get these issues resolved. We wish to stress that in offering the list below we are in no way claiming to have solved the difficult issues arising in the case of BT but merely to illustrate the general types of objective that could apply.

3. The Secretary of State might consider setting BT the following objectives:-

(i) to provide telecommunications services to meet the demands of existing customers, consistently with statutory obligations, and those of new customers;

(ii) to achieve a financial target (rate of return on assets) and to operate within borrowing limits set by the Secretary of State, and approved by the Treasury;

(iii) to improve operating efficiency in accordance with indicators of performance and quality of servie to be agreed with the Secretary of State;

(iv) to negotiate pay settlements at lowest levels consistent with adequate recruitment and other relevant factors, particularly productivity improvement;

(v) to set tariffs in accordance with guidelines agreed with the Secretary of State;

(vi) to plan a programme of investment within guidance from the Secretary of State as to both the shape and the overall size of the programme, with projects to be appraised using government-approved techniques, and the Secretary of State to be consulted on any project above a stated size;

(vii) to operate procurement policies along lines to be agreed with the Secretary of State with due regard to the long term interests of UK suppliers and in particular their international competitiveness.

The Secretary of State might also wish to set objectives in relation to privatisation and competition such as :-

(viii) to organise BT into separate profit centres, as far as this is sensible, and in collaboration with Department of Industry to set up subsidiary operating companies as candidates for privatisation or for joint ventures with the private sector;

(ix) to make progressive arrangements, jointly with the Secretary of State, so that control of BT can pass to the private sector;

(x) not to stifle new competition, eg to refrain from unreasonable anti-competitive behaviour, such as predatory pricing and abuse of regulatory powers.

4. Clearly some of these objectives interact with others and in some cases may conflict with them. In order to get a tight grip on, say, the borrowing requirement Government will need to set the other objectives accordingly. It will also need to ensure that the implications are followed through in BT's Corporate Plan and annual budgets so as to be confident that BT is set on a course that will not breach the borrowing limit.

5. To some extent BT already operates according to objectives of the kind listed in paragraph 3, as do the other monopolies. But for none of them have we found objectives clearly and concisely expressed in a single document. In some cases informal understandings exist but these are likely to conceal uncertainty in the Government's mind or a difference of view between Government and the industry. We consider below the extent to which clear objectives are currently set for BT, the difficulties that are encountered, and the extent to which further definition of objectives is required. From our knowledge of other monopolies we suspect that similar difficulties are encountered with them.

Objective (i): Servicing Demand

This objective will need elaboration. If Government believes that certain demands should take priority over others this should be stated, eg whether leasing private circuits to business users should take precedence over increasing the number of circuits available to subscribers on the public network.

Objective (ii): Financial Target and Borrowing Limit

A financial target for 1981-82 was never set formally although one was implied when last year's Public Expenditure White Paper was published. Department of Industry officials have argued with BT that the Government clearly intended that the target should have been 6½%. BT have not accepted this. Their position is that the target was 5%, as agreed in earlier years, and they have continued to plan on that basis. With regard to borrowing the Government has stated its position clearly. BT must live within its External Financing Limit (EFL), like all nationalised industries.

In April BT was set a (revised) EFL for 1981-82 of £380M. BT on the other hand have proposed an External Funding Requirement (EFR) of £500M in their latest Medium Term Plan; this remains their formal bid for funding in the current year and provides the basis of their planning. BT say that this funding is needed to permit them to carry out an investment programme which they believe they can justify on economic grounds; they also argue that they should be permitted to raise the extra £120M by borrowing from the private sector. At the present time, in the middle of the year in question, the difference between BT and Government has still not been resolved.

Objective (iii): Efficiency

In 1978 a performance indicator ('real unit cost') was agreed and targets for improvement were set. Recently BT's performance, as measured by the indicator, has declined, partly as a result of the recession. BT now argue that the design of the indicator was defective, in that it reflects events which are beyond their control, discourages investment and that, paradoxically, shedding manpower does not influence the indicator. The Department of Industry and the Treasury accept these arguments and are working with BT to design a new indicator. However it is hardly satisfactory that the defects of an indicator become evident only when performance appears to deteriorate. And it may be that the apparently good performance in the earlier years of the indicator's brief lifetime was as spurious as the apparently bad performance more recently. Another criticism is that a cost indicator, on its own, is insufficient. Costs can always be cut by reducing standards of service. A set of indicators is required which measures both costs and service standards.

Objective (iv): Pay

The 1980 Medium Term Plan did not express clearly BT's assumption about pay increases for 1980-81. We have been told that BT's intentions were not clarified in the Investment and Finance Review that followed. During the year BT negotiated a settlement with the POEU which included an 18% rise in basic rates and a 3% addition for productivity. As a result of this and other agreements, average earnings increased by 26% for the fiscal year 1980-81 relative to 1979-80. Clearly this was generous in relation to Government expectations for public sector pay. Since then Treasury officials have proposed a restriction in BT's EFL for 1982-83 to claw back some of the generosity of the 1980-81 settlement. This is an unrealistic remedy. We consider that this episode illustrates the need for the sponsor Department and the industry to assess jointly the likely outcome of pay negotiations before they start.

Objective (v): Tariffs

There has been disagreement about tariff policy. During this year's IFR Treasury officials argued for exploiting the monopoly by increasing tariffs in order to minimise the PSBR. BT, on the other hand, argued for lower tariffs on the grounds that present customers should not have to fund the investment programme;

BT believe that their investment should be supported by an element of borrowing. The Department of Industry argues that BT should be allowed freedom to bring tariffs steadily into line with the levels that will prevail when the market is opened up to competition. Because of the lack of a clear policy for tariffs Government was not able to give guidance to BT in its preparation of the Medium Term Plan, and the subsequent discussion of this key aspect of the Plan was inconclusive.

Objective (vi): Investment

We were struck by an inconsistency in the way Government appraises BT's investment. Although the investment programme for each year is subject to an overall appraisal, individual projects, spread over a number of years, are not. Most notably the System X project, which represents one of the largest investment projects ever carried out in the UK, has never been subjected to formal Government appraisal and endorsement.

Objective (vii): Procurement

BT in common with the PTTs of other major industrialised countries has a policy of purchasing almost entirely from domestic suppliers and this policy has had the support of successive administrations. But straightforward protection is not necessarily in the best long-term interests of UK suppliers since they may then become overly dependent upon a h o m e market and unable (or unwilling) to compete aggressively in export markets. The supplying industry should be encouraged to look first to export markets. BT's technical specifications and procurement programmes should be designed to support and reinforce export marketing rather than to prop up a fragmented and inward looking industry. The Government has a role in stimulating innovation and export efforts by the industry and in encouraging BT to buy British, even at some cost penalty provided that these wider aims are pursued. As an alternative BT could be allowed more freedom to purchase its equipment from abroad, on world competitive terms.

ANNEX B

BOARD SIZE AND STRUCTURE

1. This annex gives information on the present size and structure of a selection of nationalised industry boards. It also comments further on the question of improving the size and structure of boards and the experience and qualities of non-executive directors.

2. The chosen sample of industries from the transport, manufacturing and energy sectors is shown in the accompanying table. A major exclusion is that of the Post Office where the precise appointments to the proposed separate boards for Posts and BT have yet to be decided and/or announced. The numerous regional electricity boards have also been omitted to keep the table to a manageable size. It is felt nevertheless that the eleven boards covered give a reasonable cross-section against which to draw general conclusions.

Board Size

3. The CPRS considers that a board comprising 7 - 10 members including the chairman is to be preferred in most circumstances. A board of this size is large enough to meet the needs for expertise and representation at board level and small enough to ensure cohesion and effective decision-making.

4. For the majority of industries shown, it would be possible to accommodate this recommendation without statutory change but some reduction in the present size of boards would be involved. Excluding the Electricity Council, which is in an exceptional position, the selected boards comprise, on average, 13 members, including chairman, compared with an average statutory minimum of 8. BA, BS, BSC, BR and BGC stand out as being particularly large boards well above their statutory minima.

Board Structure

5. On structure, the main CPRS recommendations relate to the number and quality of non-executive directors though, in passing, we note that the majority of chairmen of boards shown in the table are full-time and, moreover, are supported by full-time deputies or chief executives.

6. The table follows the convention of dividing members (including deputy chairmen but excluding the chairman himself) into full- and part-time; for the most part, this division corresponds to the distinction between executive and non-executive directors. (Exceptions occur in the NCB and BGC where some

part-time members are on the executive pay-roll.) No particular pattern emerges: non-executive directors are in the majority in over half of the boards shown in the table. Of important boards not covered there, non-executive directors are in the majority on the BL board but not on the Rolls Royce or the present Post Office boards. The background of non-executive directors is diverse - present incumbents include industrialists, trade unionists, civil servants and academics - and varies considerably, both between and within boards. Thus there is no guarantee that existing non-executive directors, even where they are in the majority, will operate in an effective business-like fashion.

Non-Executive Directors

7. Our discussions with Chairmen and Sponsor Ministers and officials have convinced us that quite a number of present non-executive directors are not suited to the tasks which we envisage for them, notably the pursuit of efficiency; indeed in several instances they play a very passive role. We therefore suggest that sponsor Departments review the qualities of the present non-executive directors of each industry and prepare plans for selecting new ones where necessary. This process will take time but the aim should be to have a complement of non-executive directors with the right experience and attitudes as soon as possible. To this end it may be necessary to supplement natural wastage by persuading some directors to leave early.

8. We also recommend that those present non-executive directors who are of the right calibre be encouraged to adopt the new roles we propose for them. This means that sponsor Departments will have to spell out what is wanted. We suggest that sponsor Departments should act as quickly as possible on this and on our suggestions for reducing board size and appointing a majority of non-executive directors with private sector experience.

BOARD STRUCTURE OF SELECTED NATIONALISED INDUSTRIES

BOARD	STATUTORY COMPLEMENT		PRESENT STRUCTURE			
	CHAIRMAN PLUS :		SIZE EXCLUDING CHAIRMAN			
	Minimum	Maximum	All Posts	Full-time Posts	Part-time Posts	SPECIAL FEATURES
BRITISH AIRPORTS AUTHORITY	5	9	7	3	4	Chairman is full-time; Managing director post separate from Chairman's post; deputy chairman is part-time.
BRITISH AIRWAYS	7	14	14	6	8	Chairman is part-time; Deputy chairman and chief executive combined full-time post; also a part-time deputy chairman.
CIVIL AVIATION AUTHORITY	5	11	11[1]	4[1]	7	Chairman is part-time; 3 part-time members work at least 3 days a week on average. Deputy Chairman is full-time.
BRITISH SHIPBUILDERS	7	20	14[2]	5	9[2]	Chairman and deputy chairman are full-time
BRITISH STEEL CORPORATION	7	20	16	3	13	Chairman is full-time; Full-time deputy chairman/chief executive. Part-time members include 2 civil servants and 6 trade unionists.
BRITISH RAIL	9	15	14	7	7	Chairman is full-time; 1 deputy chairman full-time; 1 chief executive full-time; 2 full-time vice chairmen.
NATIONAL BUS COMPANY	5	10	10	4	6	Chairman is part-time; 1 full-time chief-executive/ deputy chairman.
NATIONAL COAL BOARD	8	14	11[3]	6[3]	5	Chairman is full-time; Statutes specify a maximum of 8 full-time members. There is a full-time deputy chairman. 1 part-time member paid as an executive of the NCB.
BRITISH GAS CORPORATION	10	20	15	6	9	Chairman is full-time; Full-time deputy chairman; 3 part-time members paid as executives of BGC.
ELECTRICITY COUNCIL	2	5	4	4	0	Chairman is full-time; Full-time deputy chairman; part-time deputy chairman post vacant.
CENTRAL ELECTRICITY GENERATING BOARD	7	9	7	4	3	Chairman and deputy chairman are full-time.

All figures based on returns from Departments received by 13 July 1981

Notes 1) Number of full-time posts shown includes member to be appointed on 1 September 1981
2) Figures exclude 1 part-time member whose appointment expires on 30 July 1981
3) Figures exclude one full-time member whose appointment expired on 14 July 1981. His successor has yet to be appointed.

ANNEX C

THE ROLE AND STAFFING OF BUSINESS GROUPS

1. Present sponsor Departments perform a wide variety of functions in relation to nationalised industries. In general terms, the departments face in two directions, as advocates within Whitehall for the industries for which they are responsible and as agents of the Government towards their industries. More particularly, Departmental functions include advising the Secretary of State on policy issues affecting the industries; ensuring that wider industrial, sectoral and national interests are taken into account by the Boards; safeguarding the investment of public funds; responding to Parliamentary Questions and dealing with Ministers' case-work; advising on legal questions and administering the statutes. The amount and nature of work required, as well as the emphasis on dealing with the nationalised industries as businesses, varies enormously between divisions and Departments. This is reflected in the widely differing numbers of sponsor officials dealing with different industries which are shown in the table at the end of this Annex. (We would stress that the numbers in this table represent very approximate estimates from Departments; they are however valid for illustrating the great variation in present numbers.)

2. As explained in paragraphs 20-28 of the main report, the CPRS believes that greater weight should be placed generally on the strategic business direction of the nationalised industries and that detailed intervention should be avoided. To this end, we propose that each of the main sponsor Departments - Industry, Energy and Transport - be reorganised internally so that a distinct Business Group can concentrate on strategic direction of the nationalised industries for which the Department is responsible, as described in paragraphs 65 to 73 of the main report.

3. This annex explains in more detail :

- the role of the Business Group in relation to the industries
- the staffing implications
- the considerations that should determine the division of responsibilities between the Business Group and the rest of the Department.

The Role of the Business Group

4. We envisage a Business Group administering Government's dealings with the industries sponsored by its Department, including :

(i) setting objectives

(ii) agreeing medium and short term targets via a Corporate Plan and an annual budget

(iii) monitoring performance and ensuring that remedial action is taken when performance deviates from targets

(iv) acting as Government's point of contact for political matters affecting the industry, assessing their commercial implications and explaining these to the rest of the Department and the Treasury.

5. Our proposals for objective setting and monitoring are described in Annexes A and D respectively. Here we describe what the work of the Business Group might be once the objectives have been set and the monitoring system set up. In order to indicate some of the more commercial aspects of the work we list below some tasks that might arise in the case of a monopoly utility; industries in a competitive situation would usually require less detailed supervision.

Revenue :

- Check macroeconomic and market assumptions; ensure that demand forecasts have been examined against alternative assumptions.
- Examine tariff policy against estimates, where appropriate, of long run marginal costs and in relation to business priorities.
- Check technical basis of price elasticity assumptions.
- Ask industry after discussion to estimate overall revenue effects of alternative tariff packages and alternative demand projections.

Costs and Efficiency :

- Negotiate a set of indicators of performance and service to customers.
- Monitor performance against the indicators and understand the reasons for variances when things go wrong.
- Ensure that external efficiency audits are carried out according to a pre-set programme.
- Check that the Board's Efficiency Audit Committee is functioning effectively.

Pay and Productivity :

- Discuss with the Board and senior management their industrial relations policies particularly in those industries where unions are exploiting monopoly power; liaise with management in their efforts to secure reasonable pay settlements and productivity improvements.
- In cases where there is a risk of an industrial dispute, establish a position that the Government and the Board will agree to support.

Capacity :

- Check required size of system/amount of plant in relation to projected demand.
- Check reasonableness of assumptions about utilisation.

Investment :

- Check that major projects have been properly appraised; examine key assumptions and check that appropriate sensitivity analysis has been carried out.
- Examine how investment proposals fit into business objectives.
- Extract a project implementation plan with annual targets and budgets; monitor subsequent progress; scrutinise overruns above a certain size.

Financial Monitoring :

- Monitor financial performance monthly/ quarterly against targets.
- Examine deviations from targets, and discover reasons and establish what action is being taken.
- Review at quarterly or monthly intervals projections for the year and likelihood of achieving annual targets especially the EFL.
- (Other monitoring is considered in Annex D).

6. In carrying out the more analytical tasks in this (purely illustrative) list the emphasis would be on the Business Group checking that the industry had itself carried out the appropriate analysis rather than the Business Group carrying out its own independent analysis, although this might sometimes be necessary. It would not be the task of the Business Group to 'second-guess' the industry but rather to ensure that industry was making a competent first guess. To carry out this function the Business Group staff would need to have the ability to know what questions to ask and to identify and probe inadequate answers. It follows that the staff would need to have business expertise, technical and numerate skills, and also a sufficient understanding of each industry. The implications for staffing are described in paragraphs 8-13 below.

7. The failings of the present system are very apparent in the Investment and Financing Reviews (IFR). The IFR ought to be the centrepiece of the relations between Government and each industry, where the latter's Corporate Plan is discussed in detail, assumptions probed, options displayed and a firm basis for financing decisions established. And yet many participants, past and present, from Government and from the industries, have told us that the Review process is ineffective; and our own knowledge of the conduct of some of the Reviews confirms this impression. When the industry produces a Corporate Plan it typically represents a set of Board decisions, rather than options for consideration. In the short time of the Review much time is spent by Government officials trying to understand the plan, to establish agreed conventions (eg for inflation adjustments) and to obtain further information. Even when, eventually, the content of the plan is examined the discussion sometimes appears to be more about winning debating points than about negotiating substantive changes.

Staffing

8. The selection of the right man to head the Business Group will be of crucial importance. The success of the change within the Department will depend on him. He will need the skill to supervise and lead by persuasion the nationalised industries for which he is responsible; men of the calibre required as Chairmen must not feel he is infringing their proper authority. He will have to convince them that because he understands business matters he cannot be hoodwinked by them and that the same talents will enable him to put their case knowledgeably and fully within the Department. On the other hand, he will need quickly to work alongside the rest of the Department in order to play a major role in reconciling the unavoidable conflicts between business

and political aims that at present occur disruptively at the interface with the industries. It will be his task to "sell" to the industries the compromises that from time to time are necessary.

9. A suitable candidate is likely to be one who has had experience in a large c o m p a n y of directing the affairs of subsidiaries by persuasion rather than by command, and through leaving detailed management in the hands of the executives of the subsidiary.

10. Turning now to the staffing of the rest of the Business Group we suggest that officials for this work be identified early in their civil service careers. Their career progression should then be designed to give them the necessary expertise and experience for the work. Some features that might be included are :-

- training (eg at a Business School);
- early secondment to a job in nationalised industries or private sector (the secondment of a Principal from Department of Industry to act as Personal Assistant to the Chairman of British Leyland is one example);
- alternatives for later secondments might be to (and from):
  - Nationalised Industries and private sector firms
  - Business Groups in other sponsor Departments
  - Efficiency Audit body such as the MMC
  - The Review Staff of the Ministerial Committee for Nationalised Industries
  - Treasury
- different jobs in same Business Group, but staying at least 4 years in each.

11. Their career should not however be limited solely to nationalised industry affairs. They might also do a job outside the Business Group to give them a wider view and experience of their Department's work. With this flexibility and the high standing of the head of the Business Group, it should be possible to design careers with expectations at least as good as those elsewhere in the civil service.

12. The Business Groups would employ numerate specialists (accountants, economists, engineers, scientists) as appropriate. We would expect that they would, in general, have the same opportunity to progress up the Business Group career structure as officials of more generalist origins; we do not see them employed simply as 'back-room' specialist advisers.

13. We see no reason why the total number of staff in a sponsor Department, reorganised in the way we propose, should need to be any greater than at present. Eventually it may even be possible to reduce staff numbers since Business Groups, with their greater expertise and experience, should be able to discharge their responsibilities more speedily than would be expected at present. However during the transition phase we suggest that a small number of staff with business experience would need to be seconded into the Business Group, on a temporary basis, from the private sector (or from the nationalised industries themselves) in order to establish the new culture, and we recognise that this might lead to a temporary increase in staff numbers. However once the new culture was firmly established staffing could revert to current levels, or lower; whilst there would still be value in continuing with a number of temporary secondments from the business world this could be offset by reducing the number of permanent officials.

Division of Responsibilities Within Sponsor Departments

14. Under our proposals the Business Group would discharge under the direction of the Secretary of State his responsibilities in relation to the industries. However the Secretary of State has wider responsibilities, notably for sectoral and regulatory issues, which although they may impinge upon the nationalised industries also impinge upon private companies operating in the same sector of the economy. We envisage that responsibilities such as these would be discharged by officials outside the Business Group, but working closely with those inside.

15. The precise division of duties will depend upon the nature of the work in each sponsor Department and can only be settled there.

APPROXIMATE NUMBERS EMPLOYED IN SPONSOR DEPARTMENTS ON NATIONALISED INDUSTRY WORK

ENERGY	COAL	GAS[1]	ELECTRICITY[2]	BNOC
	35	37	51	11

INDUSTRY[3]	CABLE & WIRELESS	POSTS	BT	BSC	BS	BL	RR
	3	7	18	10	9	9	6

TRANSPORT	BR[4]	BTDB[5]	NBC[5]	NFC[5]
	55	10	8	6

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1) Excludes gas standards branch
2) Excludes 33 posts for Electricity Meter Examination Service
3) Industry figures exclude clerical officers and assistants
4) Excludes 21 posts in the Railways Inspectorate
5) Figures include some staff whose time is only partly spent on these industries

ANNEX D

MONITORING NATIONALISED INDUSTRIES

The evaluation of plans and monitoring of performance

Introduction

1. During the course of the study, CPRS has, together with Hacker Young, Chartered Accountants, as consultants, looked in detail at the cycle of planning and monitoring of four nationalised industries, and has briefly compared the methods with those used by a small sample of private sector holding companies. The four industries chosen were BL Limited, British Steel Corporation, British Rail and the Central Electricity Generating Board.

2. We found that although the assessment of corporate plans and monitoring of performance of some of the selected industries are comprehensive and effective in other cases they are inadequate. For example, in the case of BL, officials are closely involved and generally well informed. In the case of CEGB, however, officials have an "arms length" relationship with the electricity supply industry, and are hampered by its structure, which places the Electricity Council between the Generating Board and the Government, without power to control it.

3. A full report of our study is being prepared separately; this Annex describes the main conclusions and recommendations.

Purpose of Monitoring

4. Monitoring essentially consists of comparing actual results against expectations, assessing the reasons for any divergence and coming to a view on the need for corrective action.

5. A good monitoring system should provide a sponsor Department with up-to-date knowledge of what is happening in an industry. The regular flow of information makes the Department less dependent on the answers which the industry is prepared to give to ad hoc questions. This should increase the Department's ability to anticipate problems before they occur. The build-up of knowledge should make the Department better able to understand and assess strategic options. The industry itself is likely to take more trouble if it knows that its returns are being monitored and any deviation from forecasts will need to be explained.

6. From the viewpoint of the industries, direct contact with some of them has confirmed that effective professional monitoring by Government would give the industries the following benefits:

(i) An objective appraisal of their strategies and performance.

(ii) An increase in the value of their discussions with Ministers who will be better informed and more up-to-date.

(iii) Greater assurance that Government fully understands their needs when negotiating on their behalf in international or other forums, for example, in obtaining EEC approval of BSC's Corporate Plan.

What should be evaluated and monitored?

7. To be effective, monitoring must be comprehensive. There should be a logical flow from discussion and agreement of the Corporate Plan and the development of the one-year Budget through the regular monthly reporting of results to the use that is made of the information within Government. The intelligent reading of results should be followed up by searching questions to the industries to make sure that they too have spotted potential problems, are taking action and the action is having the right effect. The information should flow onward as necessary, and in an appropriate form, to Sponsor Ministers, Treasury Ministers and all Ministers collectively, both on a regular basis and as "exception reports" when things go wrong.

8. Parts of the existing system come closer than others to the procedures we would recommend. But the main changes to current practices entail a much closer involvement on the part of officials in the assessment of the Corporate Plan, the provision of a phased Budget, monthly reporting and meetings, the monitoring of major capital projects in progress, and improvements in the system of routine reporting to Ministers. The main elements are described in more detail below.

(a) The Corporate Plan

9. The Corporate Plan should be a comprehensive medium to long term forward plan; it should cover, for example, a 3-7 year rolling forecast (depending on the lead times, certainty of forecasting market demand etc. for each industry) and describe the options, assumptions and risks, and chosen strategy for the industry. It should cover sales, manpower, profit and loss account, balance sheet, source and application of funds, cash flow, financial targets,

performance indicators and capital investment, for the industry as a whole and broken down by product Group or Division.

10. At present, the Corporate Plan is not always sufficiently detailed and does not describe alternative options available to and considered by the industry. Ministers may only be presented with one final strategy on a "take it or leave it" basis. For example, BL Limited's 1981 Corporate Plan essentially offered no serious alternative to the injection of £990 m by the end of 1982/83. BR's Plan was intended for its unions as well as the Department of Transport and as a result it lacked detail and was somewhat political.

11. Good monitoring can in turn increase the ability of Sponsor Departments and where appropriate, the Treasury, to evaluate Corporate Plans and other longer term forward strategies. For example we were told that close monitoring of BL Limited's current progress indicated that this year's Corporate Plan may contain unnecessarily large contingencies for capital expenditure. Capital projects will therefore be examined particularly carefully when the next Plan is submitted.

(b) Annual Budget

12. Once the Corporate Plan has been agreed, this will automatically establish the objectives to be monitored. A one year detailed Budget (including the forecast of cash flow and capital spending) should be made up for Year 1, phased to show month-by-month progress. The Budget summary should be directly comparable with the proposals in the Corporate Plan.

13. At present, it is often difficult to assess the significance of results in any one period because forecasts are not always phased to take proper account of expected fluctuations in activity over the course of a year. This problem has recently been discussed at E(NF), where Ministers agreed that industries should provide a breakdown of forecasts, showing how they expect to move towards their targets as the year progresses.

(c) Monthly Report

14. The monthly results, including all the main financial figures (profit and loss, cash flow etc.) should be presented in the same format as the Budget and Corporate Plan. The degree of detail should be decided by the sponsor Department in the light of the particular industry's nature and circumstances. The report

should show the latest level of key factors that formed the underlying assumptions behind the Corporate Plan (exchange rates, market share etc), with if necessary a note about the effects if an assumption proves markedly wrong. Where relevant updated cash forecasts for the next 3-6 months on a month by month basis should be provided.

15. Each quarter the monthly report should be supplemented by a further statement covering other features as set out in the Budget, including progress on appropriate performance indicators.

16. In the reports the results for the month, year to date and latest expected outturn for the year should be compared with the agreed forecasts:

(i) Operating results against Budget and last year actuals;

(ii) Actual capital expenditure against the capital budget;

(iii) Actual cash flow and EFL against the original cash forecast.

17. Where there is a substantial difference between the results and Budget, an explanation should be provided.

18. At present, the minimum periodic reports required by Government from each industry consist of a Monthly Funds Flow Statement and an exceedingly brief Quarterly Profit and Loss Statement. With the exception of some industries, e.g. BL Limited and BSC, which issue detailed and comprehensive monthly progress reports, the level of information provided by the industries, even when supplemented above the minimum requirement, is insufficient to give a comprehensive picture of their progress and difficulties.

19. The presentation of results in some of the reports is not sufficiently clear because the layout is difficult to follow. Comparison of the current figures with the budget or the previous year's results may not be easy to make. Not enough information is given about the trend of financial results and other performance indicators, except in the case of BSC whose monthly reports include graphs of trend lines. These enable the industry's progress over time to be more readily appreciated. An informative written commentary describing the reasons why certain actions have been taken should also be given.

(d) Capital Projects

20. Where capital projects are large enough to require approval by the Secretary of State, officials should be involved in the appraisal of these projects, and should

monitor their progress. It would not be appropriate for them to carry out independent post-project audits, but they should ensure that the industry does so, and should see copies of the audit reports.

21. We assume that reports on the progress of capital projects are available within an industry, but several industries (e.g. BSC) do not supply them to the Sponsor Department even for the largest projects. DEn has recently arranged to receive monitoring reports for the CEGB Heysham II project, but they are not very informative. DEn hopes gradually to extend the arrangement to other major projects, but the bulk of the investment programme will not be covered for some time.

Procedure

22. It is essential that returns should be punctual, complete and accurate. E(NF)(81) 3 reported that only five industries out of eighteen had met the four week deadline for the Quarterly Monitoring Report to E(NF). Of the remainder another five had not even provided a single-figure estimate of outturn. This tardiness contrasts with the discipline in the private sector, where Head Office would normally insist that financial information be submitted on time.

23. The Treasury said that several industries tend to omit information from the monthly and quarterly returns when prospects become uncertain. This is just when it is most important for the returns to be complete. A recent example has been that the Treasury over a period of 6 months was unable to obtain figures outlining prospects for the coming year from BR.

24. It is suspected that some of the figures supplied in a number of returns have been inaccurate. For example, in certain cases the estimates for the outturn for the year were not updated to take account of later events. Also the omission of "extraordinary items" from the quarterly return means that the profit figure shown may be unreliable.

25. Meetings should be held between the industry and officials at least quarterly and more frequently if there are substantial problems, to discuss matters arising from the results, check on action taken by the industry to stay on course in spite of changing circumstances, and generally to keep the channels of communication open and working. Where matters of judgement arise, the officials concerned should be sufficiently senior and expert to discuss these on equal terms with the top management of the industries; such discussions need not be restricted to the formal meetings.

26. In the CPRS's view the Sponsor Department should be the main point of contact with the industry. But in order to fulfil their responsibilities, the Treasury and proposed Ministerial Committee Secretariat should, as a matter of course, receive copies of papers from the industry that affect finance and strategy; these would generally include the Corporate Plan, Budget and monthly results. In addition, they should be permitted to attend the regular meetings if they wish, but this should not usually be necessary. It is important that at the monitoring meetings the Government's view should be put across to the industry in a coherent way. Officials should take care to present a united front to the industry and settle any differences they may have elsewhere.

27. Sponsor Ministers and Treasury Ministers should be kept up-to-date with a monthly summary of results for each industry in a standard format. Normally, there would be no need for this report to be more than a single-page summary table of results, with a short, punchy covering note bringing out only the important points. If there were problems, the ad hoc full "exception" reports that are made now should, of course, continue.

28. Similar, consolidated reports for all industries together should be prepared for Ministers to discuss collectively, though quarterly rather than monthly reports would probably be adequate. These reports should show the main results, covering profit and loss, sales etc. as well as cash (EFL). The results should be compared with those of last year and with phased budgets. Here again, reports on major problems in a single industry should be circulated separately.

29. We believe that some of the information coming to Whitehall may be unnecessary and could be cut out, saving the time of industry and Government officials. The CPRS questions, for example, whether it is necessary to monitor BR's weekly cash position indefinitely.

30. The regular provision of comprehensive reports by the industries should not be an onerous task. It simply requires them to put together in order the internal information which should already be available to them for the purposes of managing their businesses. If it is not available, the industry should be encouraged to improve its management information systems so as to provide the suggested data for itself as well as for Government. In our view these represent the basic minimum items of information that are needed for the efficient running of any enterprise.

Conclusions

31. The CPRS believes that the monitoring framework outlined here would provide Government with the information needed for a better understanding of, and relationship with, the industries, although the details will of course differ in each case. These recommendations are in line with good reporting practice in the private sector; they represent a reasonable basic minimum of information needed in order to have an adequate understanding of developments in each industry.

32. The CPRS therefore recommends that a detailed study should be set in train to bring the Government's monitoring practices for each industry up to this minimum standard. For the industries we have studied, Government has the statutory authority, in the case of BSC, CEGB and BR, and an agreement for BL Limited, to obtain any information and returns about the activities of the industries that it requires. If other industries are in a similar situation, no new legislation would be necessary to implement our proposals.

ANNEX E

INDEPENDENT REGULATORY AUTHORITIES

1. The main theoretical objection to returning nationalised industries to private ownership is that in many cases they are "natural monopolies" - as public utilities the structure of their products and markets is such that there is no efficient way of arranging for competing sources of supply. Hence it is argued that, to avoid exploitation of this monopoly power, ownership must remain in public hands subject to Government regulation and public accountability.

2. In principle an answer to this is to set up a regulatory agency with the power to prevent exploitation by controlling prices. If prices could be set by a separate agency at a level which requires the business to run efficiently in order to make profits, then this should be a complete answer to the argument about monopoly power. If the industry were then privatised, the owners would have the prospect of rewards and risks related to their success in running the business efficiently.

3. A separate regulatory agency can also be seen as an answer to the problem of relations with Government while an industry remains in public ownership. Once prices are set externally at a level which requires efficiency if the industry is to continue and take investment opportunities, then the main reason for Government intervention and target-setting is removed. If Ministers want the Board to act against its own commercial judgement (eg to keep open "non-commercial" railway routes), they must negotiate a deal with the Board with a level of grant to make this possible. Since the return on investment depends on cost and demand factors which leave the risk with the Board once the "efficient" price has been set by the agency, there seems no reason in principle why the industry should not raise capital in the market, on equity terms, outside the PSBR; (admittedly the Government would not let the industry cease trading, but it might make it clear that private investors would lose their capital if results were bad enough).

4. However, there are a number of practical difficulties in setting up a regulatory agency; for it to be worth serious consideration, answers would have to be found to several difficult questions:-

(i) Prices. What would be the statutory criteria on the basis of which the agency would determine prices? Clearly the present "break-even" test is inadequate, and more sophisticated tests, such as long-run marginal costs, are indeterminate and require judgement. But more serious, in a monopoly situation no method of determing prices based on costs can ensure efficiency - inefficient practices and high costs can simply be loaded on to prices. Hence the agency must get behind costs in order to judge efficiency.

(ii) Costs. On what basis could the agency determine the level of costs which was "necessary" or "efficient"? It could employ consultants to judge efficiency, but there would be no objective basis for deciding differences of opinion between it and the industry's own managers, so that the industry's rate of return would depend on its judgement. Experience with the Price Commission shows some of the difficulties. If the industry could be split into regions and their costs compared, this might be thought to give a better base for setting prices. But such cost comparisons are always difficult, because differences will at least partly be due to external factors;(how much help is the existence of the two Scottish Boards in reaching decisions on electricity prices?) If the smaller units were genuinely competing with each other, this would be a better test, but in the standard public utility case this is unlikely.

(iii) Wages. How would the agency decide an appropriate level of pay to be allowed for in prices? This is a case of the general difficulty about costs. But it also raises the question how far the agency (and hence the industry which would be carrying on the actual negotiations) would be required to take account of any pay guidelines set by the government of the day. A regulatory agency could in practice do little to hold back excessive pay rises resulting from the exercise of union monopoly power.

(iv) Investment. What criteria would be set for the agency to determine the contribution to be made from current revenue towards finance for new investment? This involves both the tests for appraising new investment (required rate of return) and the self-financing ratio (ie proportions to be raised from revenue and from external borrowing).

(v) Accountability. How far would the agency be subject to direction from Ministers and/or from Parliament? Unless satisfactory guidelines could be devised to limit its discretion, its exercise of this discretionary power would need to be kept in check by some form of accountability. But it must be doubtful whether Parliamentary accountability could bring to bear the necessary technical skill and commercial judgement. And if the Government itself retained power to over-rule the agency, this would in effect simply interpose an extra layer of authority in the present system.

(vi) Relationship with MMC. Could the MCC take on this task, or would a separate agency be needed? The MMC's public quasi-judicial method of proceeding would not fit easily into this new role, and certainly there would need to be a radical extension of its statutory functions and powers.

5. Although we have not been able to examine these questions in depth, we have looked at experience of regulatory agencies in the United States and have consulted a few people with direct experience. Among the main points are:-

(i) State regulatory agencies have generally not been given clear economic criteria as a basis for determining prices. Hence in practice they are required to balance between different vested interests, and cannot confine themselves to considerations of economic efficiency. As a result different interest groups attempt to influence the agencies through litigation. In many instances this has resulted in long drawn out and costly legal proceedings and serious delays in arriving at final decisions. Some US electricity utilities are facing bankruptcy because price applications of some years ago have not yet completed their progress through the courts.

(ii) Their main economic yardstick has been return on capital, rather than efficiency, although they can look into questions of the inefficient use of capital, and can attempt to influence operating efficiency. They sometimes commission outside studies, but do not appear to rely much on comparisons with public utilities in other States.

(iii) State regulation of local electricity undertakings creates problems when groups of undertakings seek to pool their generating facilities to improve efficiency and reduce the risks in constructing large units with long lead-times in the face of uncertain future demands.

Our initial impression was that experience in the United States, though no doubt of some relevance, is not reassuring and certainly does not offer a ready-made blueprint for the operation of a regulatory agency in the UK.

Prime Minister (through CAW)

Content?

MAP 28/VII

28 iii

PRIME MINISTER

I understand that you are intending to discuss the imminent CPRS Report on the Nationalised Industries early next week when I shall still be in hospital. [Tuesday: 10.00]

2 May I ask that in addition to Norman Tebbit both Michael Marshall and David Young be allowed to attend because they have both thought much about the methods of achieving much more privatisation than we have so far contemplated?

Yes pse.

KJ

KJ

28 July 1981

Department of Industry
Ashdown House

CONFIDENTIAL

Nat Ind

FINANCIAL SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Norman Fowler MP
Secretary of State for Transport
Department of Transport
2 Marsham Street
LONDON
SW1

27 July 1981

Dear Norman

NATIONAL BUS COMPANY: PRIVATISATION OF NATIONAL EXPRESS

Thank you for your letter of 22 July reporting the outcome of your consultations with Lord Shepherd about the possibility of privatising the National Express coach business.

I am delighted that Lord Shepherd proved receptive to your proposals thus opening the way to a major new privatisation initiative. I am bound to say that a residual NBC shareholding of 30% remains most unwelcome, but given the need to secure Lord Shepherd's cooperation I am prepared to proceed on this basis. While a shareholding of this size should not preclude classification to the private sector, it does make it all the more important the managerial and operational links between the two companies are kept to an absolute minimum and are placed on a fully commercial basis.

It is for this reason that I am concerned that we should not give Lord Shepherd any categorical assurances about the financial impact of your proposals on NBC. I can appreciate his concern that the financial position of the stage-fare operations should not be worsened, but it would be clearly incompatible with the complex negotiations which will be required to place the joint use of facilities by the two companie on a truly commercial basis to give a categorical assurance, in advance, that NBC's position would not be worsened. Similarly, I do not see that we can undertake with absolute certainty that there will be a demonstrable financial benefit to NBC as a whole as a result of your proposals. We must avoid undertakings which, at the end of the day, it may only be possible to fulfil at the expense of the Exchequer.

On this basis, while I am very happy for you to pursue your proposals with Lord Shepherd, I would ask you to avoid giving categorical assurance

about either the finances of NBC's stage carriage services or NBC as a whole at least until we can see our way clearly through some of the practical complications which are likely to be involved.

I am sending copies of this letter to recipients of yours.

NIGEL LAWSON

NATIONALISED INDUSTRY REVIEW

SUMMARY OF MAIN CONCLUSIONS AND RECOMMENDATIONS

1. The CPRS Review of the Government's Relationship with the State Trading Sector (Nationalised Industries and State-owned companies) proposes three fundamental changes in the present arrangements together with a number of subsidiary recommendations. This paper summarises the broad conclusions that have led to these recommendations, explains briefly what the recommendations are and outlines the reasoning behind each. There are immense differences between the industries and although the principles we recommend have a general validity, there will inevitably be variations in the way they should be applied to individual industries. It is also important to emphasise at the start that many of the problems facing nationalised industries arise from deep underlying causes such as the state of the economy and the extent of union power. A better relationship can assist in finding ways of dealing with these difficulties but it will not remove them. Our remit did not include looking at privatisation nor the problems of financing the industries. Our recommendations are aimed at those industries likely to remain in the public sector for the foreseeable future.

2. We are convinced that the idea of a completely arms-length relationship, however attractive in theory, is impractical. The Government, both because of the important role the industries play in the economy and as the owner who on behalf of the nation has to give them broad direction and supervise their performance, cannot avoid taking a considerable direct interest in their affairs. The aim must be to restrict intervention as far as possible to matters of strategic direction, pressing for efficiency, and monitoring of performance, and to avoid management intervention of a detailed kind. Large diversified companies in the private sector face the same problem. For the Government it is more difficult because there is a social as well as a business component in their involvement. We believe the way to reduce these difficulties is much clearer definition of the objectives for each industry.

3. If the Government is to act effectively as the owner of an industry, and successfully set objectives, press for efficiency, and monitor performance, it must be well-informed about business. This is also important if it is to succeed in getting action on shortcomings that are revealed. It cannot have the same knowledge of an industry as the Chairmen and senior executives but if there is to be proper understanding and communication, and if the arguments put forward by an industry are to be effectively probed, Government must be able to equal the basic business skills of the Chairmen and senior executives. Again, every successful complex company in the private sector has to have this equality of basic skills in order to control its subsidiaries even though it leaves the detailed management to them. This means that sponsor Departments need to contain at least one or two very experienced businessmen of proven competence who possess the ability to run an industry even though it is not their immediate job to do so. Without some people of this kind, however hard professional civil servants try to fill the gap, there is bound to be some lack of understanding, less than fully effective monitoring, some unreal expectations and unncessary shocks and disappointments. To be effective this business experience will have to be introduced at a very senior level.

4. Although each Secretary of State is clearly accountable for the industries that respond to him, the problems of the industries impact on overall Government concerns, for example the PSBR, prices, pay and employment. There is a need for the senior Ministers directly concerned to have a structured forum in which the overall problems and performance of the industries can be reviewed. For this to be effective they need the support of a very small review staff which contains top quality business skill of the same kind needed in sponsor Departments.

MAJOR RECOMMENDATIONS

5. Against this background our major recommendations are as follows.

6. Each industry should be working towards a clear set of objectives agreed with Government. Objectives should be agreed with Chairmen before appointment; the objectives would largely be qualitative with Corporate Plans and Annual Budgets filling in the detailed numbers. If either the industry or the Government wish to make a decision at variance with the objectives then renegotiation will be needed.

Reasoning: Irrespective of the quality of the individual Chairman, he will be less than fully effective unless given clear objectives of where to lead the industry. Equally if the Government wishes to intervene in an industry for wider macro-economic or social reasons which demand renegotiation of objectives, the business consequences of such action will be made explicit. Clarification would also provide a better basis for judging management performance and motivating improvement.

7. State Trading Boards should desirably be smaller (not more than 7-10 members where present statutes allow) with a majority of Non-Executive Directors who should be given a clearly detailed role with special emphasis on efficiency improvement. The non-executive directors should be clearly informed by the Secretary of State of specific tasks to perform in addition to the general statutory duties of all directors and should have an annual meeting with the Secretary of State to report progress.

Reasoning: The CPRS believes that because of the absence of the ultimate threat of bankruptcy in the public sector there are not the same pressures as in the private sector on the executive directors to improve performance. Equally the CPRS is convinced that revising the Government side of the current relationship, although necessary, will not be sufficient in itself to produce the necessary improvements; management within the industries needs to change its behaviour and non-executive directors can be an important agent for such change. It is desirable for the non-executive directors to be in the majority in order to ensure maximum effectiveness; smaller boards besides aiding cohesion should make it easier to recruit sufficient non-executives of the right quality. Their selection will be crucial; they will mostly come from the private sector and have experience of managing large organisations.

8. Three organisational changes within Whitehall are proposed:

(i) the setting up of a "Business Group" in each main sponsor Department. These Groups would oversee each sponsor Department's portfolio of nationalised industries and be primarily concerned with the industries as businesses. Civil Servants in the Business Groups would have career structure geared to the nationalised industries, stay longer in their posts and undergo special training to develop expertise. The Business Groups would be created by redeployment and no net increase in numbers would be entailed. Each Group

would be led by a very experienced businessman. To be attractive to the right man and to ensure his effectiveness, the post should be at the level of a Second Permanent Secretary. It would also be necessary to introduce down the line, preferably by secondment, people with business experience.

(ii) A strong Ministerial Committee should be established to review overall nationalised industry policy and performance. Because of the importance of the issues likely to arise and their impact on overall Government policy, the Committee should be chaired by the Prime Minister, although to relieve the pressure on her the Chancellor could sometimes deputise. (The more effective the new arrangements became the less frequently this Committee would need to meet.)

(iii) The Ministerial Committee would be supported by a very small Review Staff. They would make recommendations on policy issues, including priorities and would carry out special studies. The Review Staff should be led by an experienced businessman and could form part of the CPRS. It would need to work very closely with the Treasury, particularly on financial performance and investment review. It would also work closely with the Business Groups in sponsor Departments. The Secretariat for the Committee might be provided jointly by the Review Staff and the Treasury.

Reasoning: As stated at the beginning of this paper, Whitehall needs more understanding and knowledge of business if it is effectively to supervise the nationalised industries; business groups will facilitate this. The nationalised industries are so important to the national economy and to the Government's economic strategy that a powerful distinct Ministerial Committee is necessary, among other things, to ensure that the changes recommended in this paper are effectively introduced. To ensure that Ministers address the right issues, are adequately forewarned of impending problems, and are supported with expert advice, an active small Review Staff is needed.

SUBSIDIARY RECOMMENDATIONS

9. These are largely self-explanatory.

(a) Industries, wherever appropriate, should be split up into separate profit centres to facilitate management, control and policy making.

(b) Industries should be subject to regular efficiency enquiries, for example by references to the MMC. The non-executive directors through an Efficiency Audit Committee would be charged with supervising implementation of recommendations.

(c) Part of the role of non-executive directors should be to prevent a Chairman becoming captured by his industry. This would be further helped if the chairmanship were separated from the post of Chief Executive in suitable instances. A part time chairmanship would reinforce this but in some of the larger industries the complexity, and the extensiveness of the public role, rule this out.

(d) Morale in the industries has suffered over the last two decades; the industries are difficult to manage and constant criticism by the Government of the industries' inefficiencies while frequently justified can become merely demoralising. The Government needs consciously to motivate and encourage as well as criticise the industries.

(e) There is scope for improving the routine monitoring on the basis of better rather than much more information from the industries. Some detailed proposals on this will be put forward.

MINISTRY OF NATIONALISED INDUSTRIES

10. We were considerably attracted by the idea of a Ministry of Nationalised Industries as a means of concentrating and developing the additional expertise needed if the Government is successfully to direct and supervise Nationalised Industries. We do not recommend immediately moving to this solution, in part because of the delay entailed by the legislation that would be needed, but more because the upheaval of creating a single Ministry would in the short term add to the problems and be a distraction. With present resources, the running of a single large department that had to deal with the spread and diversity of all the Nationalised Industries would present a daunting task. We believe that our recommendations, by separating within sponsor departments the role of directing and supervising the industries from sectoral and other responsibilities, will encourage the development of greater expertise on business aspects. It will then become progressively more feasible to envisage the formation of a single

Ministry of Nationalised Industries, in effect by amalgamating business groups from the various sponsor departments, if this appears desirable.

July 1981

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NATIONALISED INDUSTRIES' INVESTMENT AND FINANCING REVIEW 1981

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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 accordnace 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 £3½bn. 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 base-line 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 turnround 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.

*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.

	£ million (cash)		
	1982-83	1983-84	1984-85
Baseline figures (Cmnd 8175 revalued and adjusted for gas levy)	1475	511	494
1981 IFR (changes since Cmnd 8175):			
Capital requirements	+395	+817	+1258
Internal resources	-2058	-2394	-1719
External finance	+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 the largest bids for additional finance are made not by the traditional loss-makers but by comparatively profitable industries such as electricity supply, British Gas, BNOC 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 BNOC. 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 Cmnd 8175 of £500m-£700m a year over the IFR period. These figures, and the underlying assumptions, are being discussed with the Board.

*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 Cmnd 8175 (although not higher than forecast by the industry in December 1980) in order to improve the supply/demand balance.

BNOC

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 increasing expenditure through the period on exploration, and on a range of developments to replace declining production from existing producing 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):

i) 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-savings. 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, BNOC, 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 BNOC, 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 revenues 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.

APPENDIX A. TABLE 1

1981 INVESTMENT AND FINANCING REVIEW

Capital Requirements Internal Resources and External Finance : Changes on Cmnd 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	+ 1	+ 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 Cmnd 8175 (of -£36m, +£89m and +£76m) have all been allocated to internal resources.

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APPENDIX A TABLE 2

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
PDC 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.

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NATIONALISED INDUSTRIES CAPITAL REQUIREMENTS

Appendix A Table 3

£ 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 Hyro-Electric Board	76	63	48	46	43	45	56	52	57
South of Scotland Electricity Board	56	43	53	65	132	234	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	468
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 Cmnd 8175	—	—	—	—	-19	-149	+394	+815	+1253

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

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APPENDIX A TABLE 4

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.

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APPENDIX A TABLE 5

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

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NATIONALISED INDUSTRIES' INVESTMENT AND
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APPENDIX B : INDIVIDUAL INDUSTRY ANNEXES

Section number	Industry
1	NATIONAL COAL BOARD
2	ELECTRICITY COUNCIL AND BOARDS
3	NORTH OF SCOTLAND HYDRO-ELECTRIC BOARD
4	SOUTH OF SCOTLAND ELECTRICITY BOARD
5	BRITISH GAS CORPORATION
6	BRITISH NATIONAL OIL CORPORATION
7	BRITISH STEEL CORPORATION
8	BRITISH TELECOM
9	POST OFFICE
10	NATIONAL GIROBANK
11	BRITISH AIRWAYS BOARD
12	BRITISH AIRPORTS AUTHORITY
13	BRITISH RAILWAYS BOARD
14	BRITISH TRANSPORT DOCKS BOARD
15	BRITISH WATERWAYS BOARD
16	NATIONAL FREIGHT COMPANY
17	NATIONAL BUS COMPANY
18	SCOTTISH TRANSPORT GROUP
19	BRITISH SHIPBUILDERS

APPENDIX B
SECTION 1

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
Capital Requirements				
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
Financed by				
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)			
Total external finance (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
Capital Requirements				
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
Financed by				
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
Total external finance (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)	-
MEMORANDUM				
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 CEGB 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 CEGB, 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

	%	
	1982-83	1983-84
stations close to completion	25	10
Drax	19	15
Heysham II	34	36
Total, stations under construction	78	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-boilering 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:

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

(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 CEGB'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 CEGB'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 conseqential reduction in the industry's fuel purchases).

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

The CEGB 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
Capital Requirements					
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
Financed by					
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
Total external finance					
	(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)	
MEMORANDUM					
9.	Assumed increase in paybill (%)	11	13	11	11
10.	Assumed increase tariff (%)	11	11	11	11
11.	Performance against target	-	-	-	-

3/4. SCOTTISH ELECTRICITY BOARDS

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
Capital Requirements					
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
Financed by					
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
Total external finance					
	(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)	
MEMORANDUM					
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.

APPENDIX B
SECTION 5

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
Capital Requirements					
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
Financed by					
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
Total external finance					
	(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 tariff (%) 1 October	15 10	12 10	11	11
11.	Performance against target	1.3	2.6	2.9	3.6
	(CCA return on assets: target 3.5% average 1980-81 to 1982-83 (see para.13 below))				

Outlook/Market Prospects

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
Major Projects				
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
Other (including essential engineering)	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 1984 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 project 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 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 expenditure.

Financing

(i) Internal Resources

9. Although at first sight BGC's internal resources have deteriorated by some £2 billion in 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

	£m outturn prices	
	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 3½ per cent is 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 3½ per cent.

(ii) External Financing Requirement

14. The EFL for 1980-81 has been achieved. BGC are forecasting that they will meet the 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 oil 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 prices 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 the 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 1982-83, 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 percent 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 (excldуing 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
Capital Requirements				
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)
Financed by				
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)
Total external finance (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 BNOC'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 BNOC throughout the review period.

2. BNOC 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 BNOC'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 BNOC'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 BNOC'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 BNOC believe. This category also includes some provision for expenditure on farm-ins and acquisitions.

Table B.6.2

BNOC 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. BNOC'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, BNOC 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 BNOC 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 BNOC's assumptions.

7. By comparison with the Cmnd 8175 figures, BNOC'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
	-139.2	-200.7	-282.9	-418.9
due to: change in revenue	-159.5	-150.4	-191.8	-181.9
increase in capital requirements	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.

APPENDIX B
SECTION 7

7. BRITISH STEEL CORPORATION

Table B.7.1

TOTAL EXTERNAL FINANCE

£m outturn prices

	1982-83	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.

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
Capital Requirements					
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
Financed by					
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
Total external finance					
	(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) (+3)	83) (+7)	98
Non-voice network	36)	46)	48
Miscellaneous	19 (+9)	23 (+11)	27
Motor transport	38 (-)	32 (-1)	36
International (including satellites	111 (+53)	110 (+33)	126
Computers	73 (-4)	83 (-2)	91
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 outturn 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)

Capital requirements	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

Internal resources	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

External Finance	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 1948-85. 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
Capital Requirements					
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
Financed by					
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)
Total external finance					
	(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

(Cmnd 8175 figures in brackets)

	outturn prices (£m)		
	1982-83	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 1977-78 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

Capital Requirements

	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

		Internal Resources*	
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

		External Finance	
	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.

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
Capital Requirements					
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
Financed by					
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	-	-	-
Total external finance					
	(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.

APPENDIX B
SECTION 11

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
Capital Requirements					
1.	Fixed assets in UK	205(+1)	249(-15)	348(-17)	367
2.	Other	-5(-8)	9(+9)	4(+3)	7
	TOTAL (1+2)	200(-7)	222(-42)	352(-14)	374
Financed by					
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
Total external finance					
	(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 paybill (%)	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 largely 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. In

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.

APPENDIX B
SECTION 12

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
Capital Requirements					
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
Financed by					
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) (-11)	54) (+37)	33
Total external finance					
	(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 (6% CCA on net assets, but including interest receivable over 3 years 1980-81 to 1982-83)	3.4%	4.5%	5.3%	5.9%

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.

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 earn 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

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.

APPENDIX B
SECTION 13

13. BRITISH RAIL

Table B.13.1

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

	1980-81 (provisional outturn)	1981-82	1982-83	1983-84	1984-85
Capital Requirements					
Fixed assets in UK	334 (-8)	348 (-34)	455 (-6)	540 (+43)	600
Other Capital Requirements (Revenue Investment)	-113) (-8)	-123) (-27)	-149) (-7)	-198) (-72)	-227
Other	-25)	-1)	-)	-)	-
Total 1+2	196 (-16)	224 (-61)	306 (-13)	342 (-29)	373
Financed by					
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 borrowing	)) 41))	))	94 (+70)) 94)	63 (+43)))	48
Total external financing (4+5+6+7)	790 (-)	912* (+45)	1,044 (+226)	1097 (+235)	1,168
Industries general inflation assumptions (%)			9.7	8.8	8.2
(Change on Cmnd 8175 attributable to this)			+6	+30	-
MEMORANDUM					
Assumed increase in paybill (%)		8.3	8.3	8.8	9.2
Assumed increase in tariff (%)		10.4	9.7	8.8	8.2
Performance against target	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 shoud 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.

APPENDIX B
SECTION 14

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
Capital Requirements					
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(-1.8)	17.3(-9.1)	19.2(-9.3)	21.3
Financed by					
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
Total external finance					
	(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	
MEMORANDUM					
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.

APPENDIX B
SECTION 15

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
Capital Requirements					
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
Financed by					
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
Total external finance					
	(4+5+6+7)	31.7(-)	40.6(+8.3)	43.6(+9.4)	45.8(+9.9)
8.	Industries general inflation assumption	12½%	10%	7½%	5%
	(Change on Cmnd 8175 attributable to this)	(-0.6)	(+0.4)	(+1.0)	(+1.1)
MEMORANDUM					
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 7½-10 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 down-turn 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 BWB 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.

APPENDIX B
SECTION 16

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
Capital Requirements					
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
Financed by					
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	0.9) (-1.0)	-5.6) (+1.3)	-5.8) (+3.7)	-3.7
7.	Long and medium term borrowing	- (-1.3)	-	-	-
Total external finance					
	(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	-
MEMORANDUM					
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.

APPENDIX B
SECTION 17

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
Capital Requirements					
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
Financed by					
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
Total external finance					
	(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	
MEMORANDUM					
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.

APPENDIX B
SECTION 18

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
Capital Requirements					
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
Financed by					
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
Total external finance					
	(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

ancilliary, 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 ancilliary 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 4½ 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 ancilliary 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. Reorgansiation 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 summaried as follows:

Table B.18.2

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

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.

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
Capital Requirements					
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
Financed by					
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
Total external finance					
	(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	-
MEMORANDUM					
9.	Assumed increase in paybill (%)	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

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-utilisaton. 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.

CONFIDENTIAL

DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

Norlund

The Rt Hon Nigel Lawson MP
Financial Secretary to the Treasury
Treasury Chambers
Parliament Street
LONDON
SW1

22 July 1981

Dear Nigel.

NATIONAL BUS COMPANY: PRIVATISATION OF NATIONAL EXPRESS

You wrote to Keith Joseph on 13 July, commenting on my letter to him of 8 July about the privatisation of the National Express coach business. I have since seen Lord Shepherd, and am glad to be able to tell you that I found him personally receptive, both to the idea of transferring National Express to a private company with a minority NBC shareholding, and also to applying the same treatment to NBC property, both operational and non-operational where there is development potential. He himself has suggested to me that this arrangement might also cover National Holidays.

He made it clear, however, that it would not be easy to carry the management and workforce of the National Bus Company along with him. He stressed that his best chance of doing this would be if he could be assured that the arrangements would not work to the financial disadvantage of the stage-fare operations of the National Bus Company. Indeed, he would want to show that there was some immediate and demonstrable benefit to the NBC.

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I recognise that the Treasury would like us to sell a larger proportion of the shares in the new company than I have proposed. But as I made clear in my letter to Keith, whilst National Express can stand as a separate business, their activities are closely intertwined with NBC's other activities at the operating level. All this can, I believe, be satisfactorily achieved through contract arrangements between the two companies. I do not see much prospect of being able to persuade Lord Shepherd that he should have a stake of less than 30 per cent in a business which will continue to be so closely intertwined with NBC.

As I have said, Lord Shepherd's cooperation is vital. Without it I would need much more detailed legislation to specify exactly what was to be split off from the NBC and how the property was to be dealt with, and I would also need to take powers to make directions that NBC, unlike all other bus undertakings in this country, were debarred from undertaking express and contract work. I am very far from certain that this would ever be practicable.

Even if we ignore these difficulties, the plain fact is that I could not prepare the legislation in time for introduction next Session. And given the pressure for short legislation, I doubt if colleagues would relish much lengthier provisions, and by far more controversial ones.

I am satisfied that provided some benefits are seen to go to the NBC I can get Lord Shepherd's personal co-operation and that we can achieve the very real benefits I described in my letter. If we reject this approach almost certainly this will mean a delay until the next Parliament. If we let this opportunity slip now, we would regret it.

CONFIDENTIAL

I am seeing Lord Shepherd together with the Chief Executive, Robert Brook, on Friday of this week to carry the matter forward. In the circumstances which I have set out, I hope you will be able to confirm that you are content for me to go ahead along the lines I propose. I must try to get this settled before the Recess.

I am sending copies of this to the Prime Minister, Willie Whitelaw, Keith Joseph, Francis Pym, George Younger, Nicholas Edwards, Michael Jopling, members of E(DL) and Sir Robert Armstrong.

Yours ever,

NORMAN FOWLER

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CONFIDENTIAL

10 DOWNING STREET

From the Private Secretary

20 July 1981

The Prime Minister was grateful for the Chancellor's minute of 9 July reporting on the recent seminar he held on the question of further privatisation.

She has noted his suggestion that there should be a study of the idea of a combined regional structure and regulatory regime for the nationalised industries but she believes it would be better to defer a decision on whether such a study should be undertaken until the CPRS report on the nationalised industries has been considered.

I am sending copies of this letter to Ian Ellison (Department of Industry), Julian West (Department of Energy), Anthony Mayer (Department of Transport), John Rhodes (Department of Trade) and also to Gerry Spence (CPRS) and David Wright (Cabinet Office).

T. P. LANKESTER

A.J. Wiggins, Esq.,
H.M. Treasury.

CONFIDENTIAL

CONFIDENTIAL" R H

20 July, 1981

The Prime Minister saw a copy of your Secretary of State's letter of 8 July to the Secretary of State for Industry, about plans to privatise National Express. She was glad to learn what Mr Fowler has in mind.

M. A. PATTISON

A Mayer, Esq
Department of Transport

CONFIDENTIAL"

Brian Griffiths 2

I am sure is right to say Robin Ibbs' "no further studies until we have looked at his study of nationalised industries."

CONFIDENTIAL

Qa 05628

15 July 1981

To: MR LANKESTER

From: J R IBBS

Regulatory Agencies/Regionalisation

Flag A

1. Your Minute of 10 July asked for my advice on the Chancellor's minute suggesting a study of a regional/regulatory regime for the nationalised industries which are monopoly utilities.

12 17/7

2. I can see the attraction of some form of regulatory body, and agree about the need for more decentralised accountable management in the industries, including the possibility of actually breaking up some of the larger ones. Our report will have something to say about both of these issues (though I am doubtful whether there is much scope for real competition between regional utilities, and we have not pursued this). As the Chancellor recognises, setting up a regulatory body or bodies to control prices in the major industries would raise difficult issues - not least the relationship with Government - and we have not had time to examine these in depth. Our quick check on US experience was not encouraging.

3. I note that the Chancellor proposes to have discussions on this with sponsor Ministers. Our own report on the nationalised industries will be available to Ministers in about a week's time, and no doubt they will want to discuss it. If in the light of these discussions Ministers conclude that the idea of setting up a regulatory regime for the monopoly industries is promising enough to justify further work, then I agree that it would be right for the CPRS to take this on as a follow-up to our main report. However, we would have a particular need for help from sponsor Departments in order to establish clearly what the practical problems are likely to be and how they might be solved.

4. I am sending a copy of this minute to Sir Robert Armstrong.

JRI

CONFIDENTIAL

17/7/81

Nat. Inst

1981

SECRETARY OF STATE FOR THE ENVIRONMENT

2 MARSHAM STREET
LONDON SW1P 3EB

My ref:

Your ref:

14 July 1981

Dear Keith

NATIONAL EXPRESS

Norman Fowler has my strong and admiring support for the contents of his letter of 8 July.

in his box 13/7

I am copying this to colleagues who received Norman's letter.

Yours ever

MICHAEL HESELTINE

Rt Hon Sir Keith Joseph Bt MP

Nat Grid Investigation

NEW ST. ANDREWS HOUSE
ST. JAMES CENTRE
EDINBURGH EH1 3SX

MAC

The Rt Hon Norman Fowler MP
Department of Transport
2 Marsham Street
LONDON
SW1P 3EB

13 July 1981

Dear Norman, in PM's box.

Thank you for sending me a copy of your letter of 8 July to Keith Joseph with proposals for the introduction of private capital into parts of the National Bus Company.

I have no objection to your broaching this topic with Lord Shepherd. It would have obvious but probably not insuperable repercussions at operational level on the Scottish Transport Group if you go ahead. The scope of your proposed legislation may have a bearing on the prospects for a similar Scottish enterprise (although more than the powers are involved on that aspect) and I would hope therefore that our officials could keep in touch as it develops.

I am copying this letter to the Prime Minister, Willie Whitelaw, Keith Joseph, Francis Pym, Nicholas Edwards, Michael Jopling, members of E(DL) and Sir Robert Armstrong.

Yours ever,

George

CONFIDENTIAL

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2 PS

✓MAT

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB
TELEPHONE DIRECT LINE 01-212 5902
SWITCHBOARD 01-212 7676

From the
Parliamentary Under Secretary of State

Rt Hon Norman Fowler Esq MP
Secretary of State for
Transport
2 Marsham Street
LONDON SWIP 3EB

13 July 1981

Dear Norman,

I have seen your letter of 8 July to Keith Joseph about the introduction of private capital into National Express.

I welcome your proposal. However, I wonder if we are right to dismiss without further study the possibility of introducing private capital into all or some of the National Bus Company's local services if necessary as part of the quid pro quo for investment in National Express. Local Authorities could, presumably, pay their subsidies to a private operator (or operators) as easily as to a public corporation - and calls of this kind are likely to be more realistic if there is an injection of private capital.

I am sending copies of this letter to the recipients of yours.

Yours ever,

Michael

MICHAEL MARSHALL

CONFIDENTIAL

FINANCIAL SECRETARY TO THE TREASURY

✓ MAD

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Sir Keith Joseph BT MP
Secretary of State for Industry
Department of Industry
Ashdown House
123 Victoria Street
LONDON
SW1

13 July 1981

NATIONAL BUS COMPANY: PRIVATISATION OF NATIONAL EXPRESS

I have seen a copy of Norman Fowler's letter to you of 8 July in which he seeks agreement to discussing with the Chairman of the National Bus Company the privatisation of the National Express coach business.

I warmly welcome Norman's suggestion and would be quite content for him to raise this issue with Lord Shepherd. However, at this stage I think it should be without commitment as to the extent of sale. We should defer, until after Norman's soundings, a decision on whether or not the NBC should be pressed to dispose of the National Express business outright, rather than retaining a substantial minority interest and, in consequence, reducing the proceeds of sale. Outright sale would be preferable in that proceeds would be higher and the business would be completely under private sector management. On the other hand, Norman points to the importance of securing the NBC Board's support for the proposal both because of the complexity and consequent delay in introduc of the legislation necessary to force sale and because of the close sharing arrangements between the stage carriage and express coach sides of the business.

If it proves essential to offer the NBC Board the opportunity to retain a stake in the new company I would like Norman to negotiate on the basis of this stake being as low as possible and certainly lower than the 30% mentioned in his letter. I am also concerned about his reference to the need for close contractual links between the NBC and the new company to permit the joint use of assets. Clearly before discussions begin it is difficult to be sure that these will not be necessary, but for the proposed new company to be in the private sector it has to be manifestly independent of control by the NBC. That will not easily be achieved, given that they are now sharing vehicles, staff and premises. If these are to be subject in the future to contractual undertakings, they will have to be fair to the shareholders of both. Hence the need for maximum separation between the two sets of shareholders, if the one company is

not in effect to be controlling the other.

In due course it would be helpful to have an indication of the value of the assets of the new company. We would also need to secure the benefit of the proceeds for the PSBR. Perhaps Norman could report to E(DL) on these points in the light of his discussions with Lord Shepherd.

I am sending copies of this letter to the recipients of Norman's.

Yours ever Nigel

NIGEL LAWSON

file

Nat Ind

BF 20.7.81

MR. IBBS
CPRS

I would be grateful for advice on the attached minute from the Chancellor - particularly on the suggestion that there should be a study of the idea of a "combined regional structure and regulatory regime" for the nationalised industries.

I am sending a copy of this minute and its enclosure to Sir Robert Armstrong.

T.P. LANKESTER

10 July 1981

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

You agreed some time ago to the suggestion in my minute of 10 March that I, together with the Ministers most directly concerned with nationalised industries, should hold a seminar with some carefully chosen outsiders on the question of further privatisation. The purpose was to distil ideas and suggestions on the development of policy with a range of people with relevant practical experience. We had in mind particularly the more radical development of our basic policy involved in challenging the need for the basic utilities to remain in public ownership or to retain their present monolithic structure.

2. The seminar was held on 29 June. A list of the participants is attached. The outsiders, especially those from private industry, made a very useful contribution. A number of interesting points emerged. One was that we may be under-estimating the scope for sale to the private sector of currently loss-making, but basically profitable, industries (such as British Airways), not of course by public flotation but by direct sale. It was pointed out that in the private sector it is by no means unknown for companies to be sold even though they are temporarily making a loss, if they are thought to be capable of profit. We might think about this in relation to some fringe activities of nationalised industries too.

3. But the main discussion was about the need for more direct and effective control of those monopoly utilities in the public sector. Strong arguments were put forward in favour both of breaking some of them up into independent regional entities, some or all of which might be privatised; and secondly of subjecting them to a new regulatory regime, independent of the Government. Ronnie Utiger for example put forward a convincing argument for regionalisation especially of electricity and perhaps gas, even

/without

without privatisation, to bring about the benefits of competition, for example, through the exercise of choice in industrial location. He also argued against having (which is in effect now the position) a gigantic monopoly with a monopoly of information facing the controlling or regulatory body, now the Department.

4. This leads me to suggest that we need a careful study of the idea of a combined regional structure and regulatory regime. There is a large literature and plenty of experience - both good and bad - in this and other countries. It would need to cover a number of difficult issues, not only the scope of regulation (over pricing, return on capital, investment, extent of monopolies) and the appropriate criteria but also how far it should be independent of Government and how this would impinge on our ability to implement particular policies e.g. on energy prices. The consumer dimension would need to be brought in and the means of making it democratically accountable and sufficiently flexible.

5. Of course you will not want to cut across the work which Robin Ibbs is doing at present but I do not believe his study will cover this subject in detail. It may be something which the CPRS might take on when they have completed their present exercise. It would capitalise on some of that experience. We might at the same time ask the Department of Energy to do some work on the practical implications of regionalisation and ultimate privatisation in relation to the gas and electricity industries who would be the main candidates.

6. Meanwhile, I propose to have some discussion with Keith Joseph, David Howell, Norman Fowler and John Biffen, whose Departments have the main sponsor responsibilities, to see what scope they think there may be in their areas for making headway in each of the ways that I have discussed. I am sending copies of this minute to them.

(G.H.)
9 July 1981

PRIVATISATION SEMINAR: Monday 29 June, 2.30 p.m. in the Chancellor's room in the Treasury

Government/Whitehall

Chancellor
Chief Secretary
Financial Secretary
Secretary of State for Industry
Secretary of State for Transport
Secretary of State for Energy
Mr Baker
Mr Lamont
Mr Clarke
Sir Peter Baldwin

Mr Ibbs
Mr Ryrie
Mr Ridley
Mr David Young

Nationalised Industry

Sir William Barlow
Sir Frederick Wood

Other Industry

Mr Trevor Holdsworth
Mr R Utiger

Merchant Banks and City

Mr T G Barker
Mr Walter Goldsmith
Mr Peter Lilley

Academics

Professor Beesley
Mr Christopher Foster

2nd Row

Mr Burgner
Mrs Case
Mr Cropper
1 Private Secretary
Mr Ian Stewart

DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

Prime Minister

Mr Fowler hopes to press ahead with privatisation of National Express.

MAP 13/VII

The Rt Hon Sir Keith Joseph Bt, MP
Secretary of State for Industry
Department of Industry
Ashdown House
123 Victoria Street
LONDON SW1

Good

8 July 1981

Dear Keith.

My Transport Act of 1980 removed the regulations which stood in the way of Inter-City coach services. The result has been the biggest increase in coach travel for half a century. One beneficiary from this has been National Express - the express coach network run by the National Bus Company - which has increased its passengers from an annual rate of about 8 million to about 12 million. This now provides the basis for a profitable business, and I think it is now time to go to the next stage, and to see how we can best introduce private capital into the operation.

There is, in my view, little prospect at present of a successful sale of shares in any of the NBC's stage carriage operations - that is, their ordinary local bus services. These are widely dependent on subsidy from local government. But there is no reason at all why we should ~~now~~ not now seek to attract private capital into the express side of the business.

National Express can stand as a separate business but we should recognise that the express business is closely intertwined with NBC's other activities at the operating level. There is a "sharing" arrangement for some vehicles,

staff and maintenance facilities. This has mutual benefits to both sides of the business. We shall need to take account of this in our new arrangements.

I propose, therefore, that all the assets of National Express (mainly coach stations and coaches) should be vested in a single company, and that NBC should offer shares in this company for sale to private investors, retaining a minority holding itself. In order to make the Company a more attractive investment, I have in mind that ownership of NBC's small amount of non-operational property plus some of its developable operational property, should also be transferred. But there will have to be close contractual links to provide for joint use of assets. The objective would be to bring in private capital to realise the development value of these sites and, at the same time, give the travelling public more modern facilities. Hitherto NBC have been unable to develop many of their sites by, for example, building shops or offices above bus stations and we cannot make public finance available for such purposes.

In order for this plan to succeed, I should need to take powers in the transport legislation which colleagues have already agreed that I can introduce next session. Provided that I can get the co-operation of the NBC Board, I would need a relatively short provision, probably only the one clause, to clarify their power to sell shares in a subsidiary plus possibly a schedule on pensions and tax. Cooperation is important because without it we would need infinitely more complex legislation which would not be ready for the next session. In order to have the support of NBC I need to be able to persuade the Board that the change is in their interest - for example by allowing them to retain a minority shareholding, say 30%, and thus a stake in the future profits of the business.

I should be grateful for the agreement of colleagues on E(DL) to my now broaching this topic as a matter of urgency with Lord Shepherd. My aim would be to see him by early next week and to secure his agreement in principle to the scheme. I will then let you and other colleagues know the outcome of this meeting. Meanwhile I would be grateful for any comments by lunch time Monday, 13 July.

I am sending copies of this letter to the Prime Minister, Willie Whitelaw, Francis Pym, George Younger, Nicholas Edwards, Michael Jopling, members of E(DL) and Sir Robert Armstrong.

Yours ever. Norman

NORMAN FOWLER

MR LANCHESTER

Nat Ind

10 DOWNING STREET

19 June 1981

Dear Leon

NATIONALISED INDUSTRIES AND THE OPERATION OF EFLs

Thank you for your letter of 17 June attached. I agree with your general conclusions. Although my suggestion would be theoretically an improvement on existing arrangements, I am now not at all convinced that it would be any improvement in practice.

I agree with you that the method of control used at present, crude though it is, is at least proving moderately effective. I am afraid that any deviation from it, on the lines I suggested, might well prove detrimental. So I unreservedly withdraw my suggestion.

Yours ever

Alan Walters

The Right Honourable Leon Brittan, QC MP,
H.M. Treasury.

Treasury Chambers, Parliament Street, SW1P 3AG

Professor Alan Walters
10 Downing Street
London SW1A 2AL

17 June 1981

NATIONALISED INDUSTRIES AND THE OPERATION OF EFLs

Thank you for sending me a copy of your note of 19 May. We have studied your idea with considerable interest. What follows is a collective Treasury assessment.

To summarise your idea, in place of an annual EFL agreed for each NI, EFLs for each industry would be fixed for several years ahead and the industries would then be allowed to trade unwanted parts of their EFL amongst themselves. The implication is that the EFL, by going to the highest bidder, would go to the industry whose marginal investment project offers the highest rate of return. This change would allow the aggregate EFL to be lower than otherwise.

To start with some points of clarification. I assume first that the scheme is only intended to apply to NIs' domestic borrowing in sterling. Grants would be excluded (these are significant only in the case of NCB and BR) and for different reasons foreign currency borrowing would also be outside. Second, as to the exact nature of the transaction, your note appears to imply that the NCB would only sell some of its EFL to BT if BT paid a rate of interest which was higher than the NCB expected from using this part of the EFL itself. I wonder if this is a necessary complication. Why could the industries not simply assign unused parts of their EFL to other NIs, with the receiving industries being responsible for paying interest to the NLF?

There are undoubted weaknesses in the present system of NI control and EFL fixing. Investment appraisal among NIs is at best uneven and it is at least partly no doubt true that industries tend to parade their good projects as if they were marginal when making a case for a higher or increased EFL. The idea of imparting an element of trade into EFL allocation in place of administrative

decision has some attractions. But the question is whether the advantages - both a better allocation of investment resources and reduced public expenditure - would be obtained in practice.

To achieve improved resource allocation, I think your ideas depend implicitly on the view that NIs seek to maximise the return on investment. This is probably no more than a partial truth. Like many private sector companies they tend to have mixed objectives, which will frequently amount to maximising the size of their business subject to a profitability constraint based on their financial target. In those circumstances trade would not necessarily allocate funds to industries capable of earning the highest returns. Indeed it might well allocate them to the monopolies, with BT bidding for a slice of the NCB's EFL (to take your example) and recouping with higher tariffs.

Nor, although EFL setting is an imperfect process, is it quite as arbitrary as you suggest. In principle, present arrangements ought to accommodate the sort of example which you quote, i.e. it is open to an industry in the Investment & Financing Review to bid for a higher level of finance in the first year and justify it in terms of cost-saving in the future; or to make a lower bid with an increase in later years.

The public expenditure gains are even more doubtful. They depend on the premise that NIs always use their allocation of external finance whether they need it or not, so that reallocation, by giving a better "fit", should reduce the aggregate totals. But the premise is not confirmed by experience. In 1978-79 and 1979-80 there was very considerable under-spending by the NIs in aggregate. The effect of trading would be to absorb the potential unused margin by one industry by transferring it to another industry which was under pressure. This might simply mean that the receiving industry was able to relax its efforts to find cost-savings elsewhere. The effect could be both to weaken internal discipline in the industries and to result in higher aggregate public expenditure.

The proposal also takes for granted that unused external finance should be absorbed by other NIs rather than used for some other purpose, such as reducing public expenditure or financing some non-NI expenditure. I would not necessarily agree with this.

It would also mean fixing the allocation of external finance for several years ahead and sticking to the figure. I doubt whether we should be prepared to surrender our options to that extent. It would mean importing a large element of fixity into public expenditure programmes over several years. As already mentioned, it removes the option of being able to claw back under-spending by the industries. On the other side there could be no certainty that the element of flexibility introduced by having intra-NI trade would be sufficient over a number of years. The major factors affecting NI finance tend to be external to the industries, i.e. fluctuations in general economic and trading conditions affecting their internal resources. While the industries, like companies in the private sector, should certainly expect to cut back on investment programmes in periods of recession, it is also reasonable for them, again like the private sector, to be able to increase their external borrowing

at such times. It would not therefore be possible, in my view, for Ministers to be sure that they could stand firm on existing EFLs over a number of years and rely on intra-industry trade to provide sufficient flexibility.

I am afraid my conclusion is that your idea would not be an improvement on current methods of fixing and revising EFLs. Imperfect as they are, our experience is that annual EFLs are not ineffective as a means of putting pressure for cost saving on the industries, and the element of flexibility in present arrangements is valuable to Ministers. I am rather sceptical about whether there would be much by way of improved allocation of resources under your proposal; and I fear it could lead to increased rather than decreased public expenditure as well as a loss of flexibility.

The EFL system is still relatively new (it is now in its fourth year of which the last two are in many ways exceptional). Certainly the system is being severely tested by the depth of the recession on the industries. It is possible that over time industries will increasingly come to desregard the limits; and at that point we may want to look for alternatives, of which your suggestion could be one. However, for the present, the existing system, crude as it is, provides a means of putting pressure for economy in the industries which in the past has been lacking. I would therefore stick to it.

LEON BRITTAN

cc Mr Cow Nat Gas 2

PRIME MINISTER

Mr. Fowler's statement on the National Freight Company did not occupy the House for long. I attach a copy.

For the Opposition, Albert Booth attacked the Government for its haste in seeking to dispose of this profitable nationalised corporation. But he found hardly any Labour backbenchers prepared to rise in support of him. The exception was Frank Dobson, who observed that the sum of £50m. mentioned in the statement was less than the 1968 valuation of NFC's land and property.

From the Government side, Jim Lester, Roger Moate, Matthew Parris and Gerry Neale all welcomed the Secretary of State's announcement. Mr. Booth had another go, asking why the TGWU had not been consulted before the morning of the statement. Mr. Fowler's response was that they had made themselves unavailable.

18 June 1981

18 June 1981

STATEMENT BY THE SECRETARY OF STATE

THE NATIONAL FREIGHT COMPANY LIMITED

The House will know that under the provisions of the Transport Act 1980, the National Freight Corporation comprising British Road Services, National Carriers, Pickfords and other well known subsidiary companies, was wound up and the assets transferred to the National Freight Company Limited. This was done with the intention of selling the shares to private investors as soon as possible. The Act made special provisions to allow me to fund the deficiency in their pension scheme from the proceeds of sale.

Flotation has not so far proved practicable, but I can now tell the House that I have, within the last few days, been approached by a group of the Company's senior managers. They are seeking outside financial backing with the intention of putting together a widely based consortium of managers and employees to purchase the Company. Their proposal, which indicated an offer worth in excess of £50 million, is at present at an early stage and there are still a lot of details to be worked out. I have encouraged them to press on with their plans. At the same time I am considering it with my financial and legal advisers. All this will take a few weeks.

This is an imaginative and exciting proposal and I have told the managers concerned that I hope it will prove possible to achieve such a sale.

Booth
profitable discussion

Ross

Lester

Dobson
£50m less than
1968 valuation of NFC
land + property

Moate

Parris

Booth
Was TGWU consulted
before this a.m.
Fowler

Neale

Prime Minister

This is the present version of Mr Fowler's NFC statement tomorrow. He may revise it further overnight.

MAP 17/VI

COMMERCIAL IN CONFIDENCE

THE NATIONAL FREIGHT COMPANY LIMITED

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Flotation has not so far proved practicable. But I can now tell the House that I have, within the last few days, received a conditional offer, worth in excess of £50m, from a group of the Company's senior managers who are intending to put together a widely based consortium of managers and employees to purchase the shares and to take over the control of the Company.

This is an imaginative and exciting proposal which, if achieved, will transfer the ownership of the Company to its employees. I have told the group of managers concerned that I hope it will be possible to achieve such a transfer. But I shall need to consider this offer with my financial and legal advisers. This will take a few weeks. In the meantime, I have encouraged them to press ahead with their plans.

MF.

CONFIDENTIAL

Not Ind.

10 DOWNING STREET

From the Private Secretary

Sir Robert Armstrong

I minuted you on 2 April saying that the Prime Minister had decided that the Chancellor should take over the Chairmanship of E(DL), subject to her first discussing the matter with Sir Keith Joseph.

In the light of Press speculation over the weekend about Sir Keith's future, the Prime Minister has now decided that she does not wish to make any change in the Chairmanship of E(DL) for the time being. I have explained this to John Wiggins in the Treasury.

TL

29 May, 1981.

CONFIDENTIAL

cc: Mr. Lankester - No.10

MR. A. WALTERS - NO.10

NATIONALISED INDUSTRY FINANCING

The Chancellor was very grateful for your letter of 1 April. He thought it would be helpful for you to know of the Treasury's comments on it.

2. So far as the telecommunications investment, which precipitated the discussion, is concerned, there appears to be general agreement that this should go ahead - and the Chancellor has now written to the Industry Secretary in this sense. The question is what, if anything, has to be given up in order to make room for this additional investment.

3. The first question to answer is whether the Government should be ready to see an increase in aggregate public spending. Given the Government's general objective of reducing the size of the public sector, there is something of a presumption that the right way to find the money for the additional telecommunications investment would be to reduce other public spending programmes. Only if such reductions cannot be achieved do we have to consider the next question.

4. If some other item of public expenditure cannot be "crowded out", do we then have instead to crowd out some private sector spending or can we allow total spending, public and private, to rise? In practice an increase in total spending seems hardly consistent with the Government's monetary strategy. The intention of the monetary target is surely to constrain the growth of total income in nominal

terms - we assume the velocity of circulation to be stable in the medium term. This policy is rather like subjecting the economy as a whole to a cash limit - applying to the private as well as the public sectors. Of course the control cannot be as precise as this argument in its simplest form might suggest, but the intention is undoubtedly to restrain total spending in cash terms. In these circumstances if the financial markets do not crowd out some part of private spending to make way for the extra public investment, then sooner or later policy measures will have to be taken to achieve this effect.

5. One answer given to this has been that the new investment would be self-financing because of the saving in unemployment benefit and the additional tax revenue generated. Although some part of the direct cost to the PSBR of employing additional labour would be offset in this way, the savings would in the Treasury's view cover only about half of those costs; there would also be additional non-labour costs associated with an increase in public sector investment, and these would add to the net adverse impact on the PSBR. (All this was explained in more detail in an article in the February issue of the Treasury's Economic Progress Report.)

6. Alternatively, could we rely on additional spending in nominal terms adding to real output rather than prices? This approach has, of course, been explicitly rejected by the present Government, and both the Prime Minister and the Chancellor have repeatedly made the point that the only result of seeking to add through fiscal means to the level of demand has been a continuing secular increase in both unemployment and inflation. The Government recognise that, during the transition to slower growth of money and prices, real as well as nominal output and spending will be reduced because of the lags in the adjustment of prices. This is the price we have to pay in the short run for reducing inflation. But subsequently inflation can be expected to abate, and real

output to recover. Recent experience shows this process in operation; there has been a sharp slowdown in the growth of total spending in nominal terms but, because prices have still been rising too rapidly, some of this has been at the expense of real output. The forecast now is for inflation to slow down gradually, permitting an upturn in economic activity. Meanwhile there is appreciable spare capacity; but to the extent that this spare capacity is brought into use by additional expenditure, whether public or private, the reduction in the rate of inflation is threatened, or at least postponed.

7. The question remains, within the framework set by the MTFS, what the appropriate mix should be between investment and consumption. In the private sector we can leave the choice to the markets for savings and for investment goods, but in the public sector the outcome is inevitably rather more arbitrary. It is therefore all the more necessary to do whatever we can to improve public sector investment appraisal and decision-making, so as to improve the overall allocation of resources. If the Government's economic stance is to be maintained, there seems to be no escape from addressing these difficult questions; we cannot avoid them by reference to quite separate arguments about the extent of spare resources in the economy.

JW

(A.J. WIGGINS)
29 April 1981

Ref. A04699

MR. LANKESTER

Nationalised Industries

With my minute of ~~3rd~~ TOM April, I enclosed a draft minute to Mr. Ibbs which you subsequently sent to him. It was agreed that no full record of the 31st March meeting should be circulated, but a record has been drawn up which will be kept on our files. I enclose a copy for No. 10 files.

D.J. WRIGHT

10th April, 1981

c4c. Marks

CONFIDENTIAL

Note of a Meeting at 4pm on Tuesday 31 March at 10 Downing Street, to discuss the relationship between Government and the Nationalised Industries.

Present: The Prime Minister, The Chancellor of the Exchequer, The Secretaries of State for Industry, Energy and Transport, Mr Ibbs, Sir Robert Armstrong, Mr Le Cheminant and Mr Moore.

THE PRIME MINISTER said that there had been a number of major instances within the last year of nationalised industries and publicly owned companies, such as BL, tabling proposals for substantial additional public expenditure too late for Ministers to have the opportunity to call for analysis of alternative approaches. The result was that the Government had responsibility for financing these industries but no effective means of controlling the flow of public finance to them. This called for an urgent and radical re-examination of the relationship between Government and the nationalised industries, as well as companies dependent on Government financial support, and of the present methods of monitoring their financial performance and forecasts.

In discussion the following were the main points made:-

(a) To some extent the financial problems of the industries resulted from falling markets and the high exchange rate. These problems were, however, faced by the private sector too. The right approach was to distinguish between external factors, which were outside the control of the industry, and those internal factors for which an industry could set objectives and be held accountable; in this way adverse movements in external factors could not be used as an excuse for the overall

CONFIDENTIAL

performance of the industry. Once objectives were set on this basis, Government should arrange for them to be monitored closely and monthly and should ensure that forecasts were revised in good time so as to avoid changes later in the financial year. The objective should be to secure a measure of control broadly comparable to that of a holding company, but not for the Government to assume, or to be thought to be assuming, responsibility for the management of the industries.

(b) Monthly financial returns were already made to sponsoring Departments but it was now necessary to make this system work effectively. Each industry should be required to present annotated accounts monthly and in a common form. The internal accounting systems of some of the industries, notably British Telecommunications, was weak and needed to be improved urgently.

(c) The ability of staff within the sponsoring Departments and the Treasury to appraise monthly returns, forecasts and investment proposals needed to be reinforced. Consideration should be given to calling in outside experts with direct experience of dealing with these problems in the private sector. The recent report of the Monopolies and Mergers Commission on the Central Electricity Generating Board illustrated how outsiders could be more effective than Departments in obtaining detailed information and presenting analysis of it. It should not, however, be necessary to set up any central unit within Government to deal with these questions.

(d) In parallel with improvements to the present systems of monitoring and control, pressure should be maintained to privatise public sector activities where practicable and to break up monopolies by the introduction of competition. Consideration should be given to breaking up some industries, such as the National Coal Board, into regional boards. If it were thought that legislation was inhibiting progress, proposals should be put forward for changes. It was noted that the Chancellor of the Exchequer might wish to put forward proposals for the

speeding up of privatisation measures, and that the Secretary of State for Energy would consider whether he wished to make any further proposals for breaking up the monopoly powers of the industries for which he was responsible.

THE PRIME MINISTER, summing up the discussion, said that the Meeting agreed that the Central Policy Review Staff should undertake an urgent review of what should be the basis of the relationship between Government and nationalised industries, and companies dependent on financial support from Government, and how best to give effect to that relationship so as to ensure a reasonable balance between the commercial responsibilities of the Boards, and the supervisory responsibilities and financial commitments of the Government; their review should deal in particular with the adequacy of the present arrangements for monitoring the financial performance of the industries and for giving warning in good time of troubles ahead. The CPRS should consult the Treasury and each of the sponsoring Departments and, through them, any of the nationalised industries which they wished to approach. The report would be their responsibility and Departments would not be committed by it, although they should give the CPRS every assistance in its preparation. The report should be submitted to her, and the other Ministers concerned, in time for it to be discussed before the Summer Recess.

THE MEETING -

Took note, with approval, of the Prime Minister's intention to arrange for a letter to be sent to the Head of the CPRS inviting him to carry out a review on the lines indicated in her summing up of their discussion.

CABINET OFFICE

Central Policy Review Staff

With the compliments of

J. R. Ibbs

70 Whitehall, London SW1A 2AS

Telephone 01-233 7765

Nat Ind

CABINET OFFICE
Central Policy Review Staff
70 Whitehall, London SW1A 2AS Telephone 01-233 7765

From: J. R. Ibbs

Qa 05310

7 April 1981

Dear Lord Weinstock,

It was interesting and helpful to attend your meeting for two hours on Friday afternoon. Thank you very much for providing this opportunity.

I should be grateful if I could have a further talk with you about the nationalised industries. Possibly soon after Easter might be appropriate because by then I should have formulated more clearly some specific issues on which I should like to know your views. I shall get in touch with your office to see whether a suitable date can be arranged.

Yours sincerely,

J R Ibbs

The Lord Weinstock
1 Stanhope Gate
LONDON W 1

Ec Brigid Walters 1 Apr

CONFIDENTIAL

1st Apl

10 DOWNING STREET

From the Private Secretary

MR IBBS

Nationalised Industries

At her meeting on 31 March the Prime Minister discussed with you, the Chancellor of the Exchequer and the Secretaries of State for Industry, for Energy and for Transport current problems in the relationship between Government and the nationalised industries.

Ministers invited the Central Policy Review Staff to review what should be the basis of the relationship between Government on the one hand and nationalised industries (and companies dependent on financial support from Government) on the other, and how best to give effect to that relationship so as to ensure a reasonable balance between the commercial responsibilities of the boards, and the supervisory responsibilities and financial commitments of the Government. Ministers wish you to consider in particular the adequacy of the present arrangements for monitoring the financial performance of the industries and for giving warning in good time of troubles ahead.

In carrying out this review you will need to consult the Treasury and each of the sponsoring Departments and, through them, any of the nationalised industries which you may want to approach. The report will be your responsibility, and Departments will not be committed by it, although the Prime Minister expects them to give you every assistance in preparing it. You are free to seek such other advice, inside or outside Government, as you consider appropriate.

You should aim to submit a report to the Prime Minister, with copies to the Chancellor of the Exchequer and to the other Ministers with responsibilities for nationalised industries, in time for discussion before the summer recess.

The meeting took note that, in the meantime, the Chancellor of the Exchequer might wish to put forward further proposals for speeding up progress with privatisation, and that the Secretary of State for Energy would consider whether he wished to make any further proposals for breaking up the monopoly powers of the industries for which he is responsible.

I am sending copies of this letter to the Private Secretaries to the Chancellor of the Exchequer, to the Secretaries of State for Industry, for the Environment, for Scotland, for Trade, for Energy and for Transport, and to Sir Robert Armstrong.

TPL

3 April 1981

Ref: A04628

MR. LANKESTER

Nationalised Industries

It was, I understand, agreed at the Prime Minister's meeting on 31st March that only the conclusions of the meeting should be circulated to those who attended. Since the meeting resulted in a remit to Mr. Ibbs, this might be best done in the form of a letter from you to Mr. Ibbs. I attach a draft which has been approved by both Sir Robert Armstrong and Mr. Ibbs.

D. J. Wright

(D.J. Wright)

3rd April 1981

DRAFT LETTER FROM MR. LANKESTER, No. 10 to
MR. J.R. IBBS, Cabinet Office

Nationalised Industries

At her meeting on 31st March the Prime Minister discussed with you, the Chancellor of the Exchequer and the Secretaries of State for Industry, for Energy and for Transport current problems in the relationship between Government and the nationalised industries.

2. Ministers invited the Central Policy Review Staff to review what should be the basis of the relationship between Government on the one hand and nationalised industries (and companies dependent on financial support from Government) on the other, and how best to give effect to that relationship so as to ensure a reasonable balance between the commercial responsibilities of the boards, and the supervisory responsibilities and financial commitments of the Government. Ministers wish you to consider in particular the adequacy of the present arrangements for monitoring the financial performance of the industries and for giving warning in good time of troubles ahead.

3. In carrying out this review you will need to consult the Treasury and each of the sponsoring Departments and, through them, any of the nationalised industries which you may want to approach. The report will be your responsibility, and Departments will not be committed by it, although the Prime Minister expects them to give you every assistance in preparing it. You are free to seek such other advice, inside or outside Government, as you consider appropriate.

4. You should aim to submit a report to the Prime Minister, with copies to the Chancellor of the Exchequer and to the other Ministers with responsibilities for nationalised industries, in time for discussion before the summer recess.

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6. I am sending copies of this letter to the Private Secretaries to the Chancellor of the Exchequer, to the Secretaries of State for Industry, for the Environment, for Scotland, for Trade, for Energy and for Transport, and to Sir Robert Armstrong.

DEPARTMENT OF TRADE 1 VICTORIA STREET LONDON SW1H 0ET Telephone 01-215 7877

From the Secretary of State

The Rt Hon Leon Brittan MP
Chief Secretary
HM Treasury
Parliament Street
London SW1

2 April 1981

Dear Leon,

NATIONALISED INDUSTRY FINANCIAL TARGETS

Thank you for copying to me your letter of 17 March to Keith Joseph. So long as we claim that financial targets have primacy in the regime of Government control over the performance of nationalised industries I can understand your wish to give regular publicity to the progress of individual industries in meeting their targets. However I do have some reservations.

First of all we must bear in mind that for most nationalised industries, the major determinant of performance against a financial target is the economic climate within which they operate. In many cases the assumptions made at the time financial targets were agreed have proved over-optimistic and I wonder whether it is really in the Government's interests to be continually drawing this to the public attention.

I am concerned too that in doing what you suggest too much emphasis will be placed on this single element in assessing the performance of each industry. We have agreed that performance and efficiency cannot be measured solely in terms of financial targets; and it would be wrong to set aside any achievements, or indeed failures, measured against other performance aims, where these have been agreed.

From the Secretary of State

But my main concern relates to your suggestion that remedial action should be identified by the industry and publicised by the Government in cases where performance against a target has slipped. There are bound to be instances (and British Airways is one) where the circumstances are such that it will be impossible for an industry to recoup the slippage in the remaining years of the target. In such cases the only courses open to the Government are either to revise the target downwards; to exhort the industry to make up as much ground as it can; or to stay silent about the remainder of the target period. Whichever course we adopt in such cases it will only serve to expose the weakness in the financial target policy when applied to industries who are price takers in a competitive market.

Some remedies may be highly sensitive in political terms and should therefore not be publicised in the context of financial targets. An obvious example would be that of a monopoly industry where price rises are a subject of increasing public or industrial concern. Another is where the only remedies to meet a financial target may be large scale closures and redundancies. A statement about an industry's performance against its target could well be entirely the wrong occasion on which to unveil such measures and might only present the industry (and the Government) with greater difficulties in implementing the necessary changes.

Even if colleagues generally are prepared to support your suggestion and to live with the difficulties which I have mentioned, I think it is impossible to lay down a standard procedure for all occasions in the detail you propose. Sponsoring Ministers must retain discretion over the form and content of individual statements and be free to accommodate them to the particular circumstances and considerations - political and other - which are relevant at the time.

From the Secretary of State

I suggest that the most I could sensibly agree now is that, in principle, statements of performance against targets, financial and other, should be made by the Government, but their contents should be considered case by case when the time for publicity in respect of each industry comes around.

I am copying this letter to recipients of yours.

Yours

John Biffen

JOHN BIFFEN

CONFIDENTIAL

cc. D. Duguid
Nat Ind
BF 6/4

10 DOWNING STREET

From the Private Secretary

Sir Robert Armstrong

Nationalised Industries: Privatisation

You minuted me on 24 March about the chairmanship of E(DL). I showed your minute to the Prime Minister, and she has now discussed the matter with the Chancellor.

The Prime Minister expressed her doubts about the Chancellor taking over the chairmanship of E(DL) at this stage, as he had proposed, particularly in view of his heavy workload. However, the Chancellor argued that the work of E(DL) could be carried forward more effectively under Treasury chairmanship.

The Prime Minister agreed, somewhat reluctantly, that the Chancellor should take over the chairmanship, subject to her first discussing the matter with Sir Keith Joseph. The Chancellor said that he had already mentioned it to Sir Keith who had seemed quite prepared to relinquish the chairmanship. But he of course accepted that nothing should be done until the Prime Minister had spoken to Sir Keith.

T. P. LANKESTER

2 April, 1981.

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cc D. Duguid
Nat Ind
PF 6/4

10 DOWNING STREET

From the Private Secretary

Sir Robert Armstrong

PM decision on change for chairmanship

Nationalised Industries: Privatisation

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The Prime Minister agreed, somewhat reluctantly, that the Chancellor should take over the chairmanship, subject to her first discussing the matter with Sir Keith Joseph. The Chancellor said that he had already mentioned it to Sir Keith who had seemed quite prepared to relinquish the chairmanship. But he of course accepted that nothing should be done until the Prime Minister had spoken to Sir Keith.

L.P. LANKESTER

2 April, 1981.

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fe KB

MR. WALTERS

cc: Mr. Wolfson
Mr. Hoskyns
Mr. Duguid
Mr. Strauss

I was interested, but puzzled, by your letter of 1 April on nationalised industry financing. If, as you suggest in the penultimate paragraph, we should risk a very modest expansion in public sector demand through higher investment by BT, why was it necessary to go for a PSBR in 1981/82 of £10½ billion rather than, say, £11 billion?

This is not to say that I am against additional investment by BT: on the contrary.

T P LANKESTER

CS

2 April 1981

CONFIDENTIAL

CONFIDENTIAL

cc Mr. Lankester
Mr. Wolfson
Mr. Hoskyns
Mr. Duguid
Mr. Strauss

10 DOWNING STREET

1 April 1981

Dear Geoffrey,

NATIONALISED INDUSTRY FINANCING

My No. 10 colleagues and I were grateful for the opportunity to debate this issue with you and your officials on 30 March. We still seem to disagree on a number of points. I shall attempt to set these out below.

First of all, the problem we are trying to address is how to accommodate extra investment in profitable capital projects in nationalised industries. We know that there are difficulties about establishing the profitability of some projects - and that the judgment of the management of nationalised industries is not a sufficiently reliable guide. For example, I am dubious about the benefits claimed for large-scale railway electrification. You seemed sceptical yesterday about the value of extra telecommunications investment. However, Mr. Burgner's minute of 16 March shows that an economic case for essentially cost-reducing investment has been made to the satisfaction of your officials. (Bill Ryrie said that one of the convinced officials concerned was the most sceptical man in the Treasury!)

Everything else that follows in this letter assumes that a very strong economic justification for the extra investment has been made. It is important to establish this at the outset because we have no wish to see the floodgates open to NI investment regardless of its merits.

We are all agreed that the medium term goal is to privatise BT as much as possible and that any early steps in that direction are desirable. However, we are assuming here that this cannot be done in time to help solve the immediate problems.

Case 1: Assume 100% Crowding-Out

Let us assume that the extra capital investment does, as Peter Cropper argues, displace other investment of equivalent cost. Ideally, of course, we would all like to see it displacing other public sector investment - or, still better, public consumption. The one thing we all agreed on last night was that it would be highly desirable to re-order Government priorities - raising some categories of investment and reducing other categories of spending. Ideally there should be a "hit list" of disposable or at least

/deferrable spending.

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deferrable spending. However, as I understand it, your present political judgment is that there is no scope for this during 1981/82.

This means that the extra investment in, say, BT (which we accept is irrefutably in the public sector for the time being) will crowd out an equivalent amount of investment in the private sector. But since the marginal return on private sector investment is a good deal lower than for this project, there will have been a net gain.

This displacement of a low return by a highly profitable project is a "good thing". But I accept that there are three further arguments which might be advanced by the Treasury:

a. It would mean a net transfer from the private to the public sector - which is contrary to our broader objectives. I would not be concerned about this in a case, like BT, where we see medium-term prospects of privatisation.

b. There is a risk that the pressures on management and unions to strive for efficiency will be weakened. This danger is real. Disciplines on management are obviously needed, though we doubt whether it would be at all realistic to threaten the unions with withholding marginal cost-reducing investment.

c. The mechanism by which this project has displaced the other has, in theory, some monetary consequences. These are uncertain and probably negligible. It seems wrong in principle to us to make monetary objectives so paramount that we prefer to forgo the expected benefits from the extra investment, rather than risk a minor monetary consequence. The monetary consequences would be:

Either:

i. The extra spending counts towards the EFL and thus raises the PSBR (even if it comes off the contingency reserve, there is a high chance that the reserve will be exhausted during the financial year that this project will simply ensure that other projects add to the PSBR). If the extra PSBR is financed through gilt sales, there may be upward pressure on interest rates. A slightly increased PSBR compromises the MTFS targets and may have psychological effects on the markets.

Or:

ii. If the project is financed by some device which modified rules regard as outside the EFL, then the PSBR would be unaffected. However, to a greater or lesser extent, the funds would be met by Bank lending which would increase M_3. If, per contra, the funds were provided by loans, such as bonds, which do not affect M_3, then they would compete with gilts - driving up interest rates. But the crowding out will be of inferior projects.

Case 2: Assume less than 100% Crowding-Out

If the investment does not crowd out other private sector projects, then it will constitute a net addition to demand with more serious monetary consequences.

However, it is as unlikely that there will be 100% as 0% crowding-out. With unemployed resources at their present level it is likely that, if the project is financed by a PSBR increase, or additional bank lending through lease back, there would be some additional demand. This would have expansionary effects. If we take a rather high figure and suppose that 75% of the project costs is additional and only 25% is crowding-out, what are the consequences?

This depends. Suppose that we hire those who would otherwise have been unemployed in the West Midlands, etc and plant which would otherwise have been idle. Then it is easy to see that, provided it has no effect on wage settlements (and I know this is a big proviso), the fall in unemployment benefits (roughly 75% of the wage earnings net of tax and NIC)will give a matching reduction in the PSBR. The net effect on £M_3 will depend on the fraction of the wage bill in the project - but if the wage bill is less than 100% of the value added, the net effect on £M_3 is negative, bothin the year of investment and much more negative in the subsequent years when the investment fructifies.

The critical issue is the effect of such additional demand on real wage settlements. If the new demand set off a round of higher wage settlements, higher unemployment and PSBR, then the issue is much more equivocal.

It is a matter of judgment, then, on the wage settlement issue whether the investment should be financed by allowing additional private borrowing from the banking system (through a lease back arrangement for example) or whether one should issue more gilts and so assume a 100% crowd-out.

We realise that the arguments that some additional expenditure may be accommodated without inflationary consequences is generally incorrect. That we accept. However, we also know the lessons of history. Friedman himself (in Friedman and Meiselman in Stabilization Studies CMC 1953(?)) pointed out that in the depths of the slump in 1931, the Keynesian model was superior to the monetary model (and it was the only period when this was the case). It is a moot point whether we are now in a similar situation. I do not think that the analogy is very close let alone perfect - after all we still have a 10 per cent or so underlying inflation compared with a plummeting price level in the USA in 1931. But in my judgment it is near enough for us to risk at least the very modest expansion in highly profitable investment of BT. On the above arguments we can hardly make an enormous mistake and we seem likely to generate very considerable benefits.

We still think there is a strong case for allowing demonstrably highly profitable investment to go ahead - even on the assumption that it crowds out other, less profitable investment in the private sector. We accept that it is not without risks, but these seem to be outweighed by the benefits.

Yours

Alan

The Right Honourable Sir Geoffrey Howe, MP.

NOTE OF A MEETING HELD AT NO.11, DOWNING STREET AT 4.30 PM ON MONDAY, 30TH MARCH, 1981

Present:

Chancellor of the Exchequer (in the chair)
Chief Secretary
Financial Secretary
Mr. Ryrie
Mr. Burgner
Mr. Monck
Mr. Ridley
Mr. Cropper
Mr. A. Walters) No.10
Mr. D. Wolfson) Downing St.
Mr. A. Duguid)
Mr. D. Young (Dept. of Industry)

NATIONALISED INDUSTRIES INVESTMENT

The meeting was held to consider the case for, and the ways of financing, additional investment in the nationalised industries; there was an immediate issue of particular importance where British Telecom (BT) had sought an increase of £200 million in available external finance.

2. The Chancellor asked the Policy Unit representatives and Mr. Young whether they accepted the analysis in the memorandum prepared by Mr. Cropper. They made the following points in response:-

(i) Substantial real resources were currently lying idle in the British economy; drawing these back into employment need not be inflationary, and would strengthen the UK's economic infrastructure.

(ii) There was a good deal of scope for additional investment by the nationalised industries, which would yield substantial real returns.

(iii) The available returns would be appreciably larger than those accruing in respect of marginal

investments in the private sector. Thus even if the additional nationalised industry investment "crowded out" an equivalent amount of private sector investment, there would still be a net benefit to the economy. (The Policy Unit did not accept that there would be 100 per cent "crowding out".)

(iv) Techniques were available to finance the investment without adding to the PSBR. Possibilities were raising money through the sale and lease back of property, or through leasing the new equipment in question. The further point was made that an "operating" lease could yield a substantial efficiency benefit, in that the performance of the asset remained the responsibility of the private sector supplier rather than the nationalised industry using it. (This technique was particularly appropriate in the case of equipment used by the transport industries).

(v) Substantial funds were available for financing additional nationalised industries investment; GEC, for example, were likely to increase investment overseas if BT did not maintain the momentum of their purchases of telecommunications equipment.

3. The Chancellor and other Treasury representatives replied as follows:-

(i) Investment by nationalised industries was not subject to market tests in the same way as private sector investment; in a number of cases adequate returns could be secured by exploiting a monopoly position without any progress being made towards greater efficiency, and in all cases the Government in effect guaranteed the industries' borrowing from whatever source. Thus it was not possible to make exact

comparisons between the returns on alternative investments in the public and private sectors.

(ii) If there were to be any question of drawing private sector finance into certain nationalised industry investments, this should be associated with arrangements whereby the returns to the private investors depended on the performance of the investments and the investors shared in their management. The Treasury were exploring various aspects of this partial privatisation approach in those industries where total privatisation was not feasible.

(iii) It was possible that financing nationalised industry investments other than through NLF lending could contribute to greater efficiency, and - for a given investment programme - might have a somewhat smaller direct expansionary impact on £M3. On the other hand, additional investment, however financed - and whichever side of an arbitrarily defined PSBR it fell - would represent an additional demand for credit in the economy which, given the Government's monetary target, could only be financed either at the cost of an increase in interest rates or a reduction in other public expenditure or an increase in taxes. There was a sense in which the Policy Unit's advocacy of a higher level of investment in the nationalised industries implied a net increase in demand in the economy and a relaxation of the monetary target.

(iv) The Government had deliberately decided to give priority to activity in the private sector, and had therefore reduced interest rates even at the cost of higher taxation. It was inevitable that the private sector would not be able instantly to take up the room in the economy created by the additional taxation -

but this was a temporary cost of adjustment which could not be avoided if the private sector were to be revitalised as the Government wished.

(v) Much nationalised industry investment was not particularly profitable, and the Treasury would be working to try to achieve a better ordering of priorities within the total programme. Control of each industry's external financing was the only weapon available to the Government with which to apply pressure for greater efficiency. If additional investment were to be agreed in BT, it was strongly desirable that this should be financed, at least in part, through cost reductions. The Post Office had been substantially shielded from pressure for cost reductions, and the need now for additional external finance mainly arose because of BT's failure to meet their financial target. (It was noted that a 5 per cent reduction in BT's pay bill would produce most of the £200 million for which BT had originally asked - but BT might now raise their bid to £300 million.)

4. The Chancellor, summing up the discussion, said that he appreciated the strength of the case for additional investment in the nationalised industries, and in particular in BT, and that he recognised the need for an early decision on the latter. But he did not see diversification of the sources of finance, not associated with other action to subject parts of nationalised industry operations to market disciplines, as removing the need for controls over nationalised industries' investment and external financing; these controls were needed both as a means of applying pressure on the industries to become more efficient, and in order to contain the aggregate burden of the public sector on the rest of the economy, given the monetary target. If investment reductions by BT were to be avoided, the appropriate course in present circumstances

appeared to be an increase in the external financing limit, which would be a charge on the contingency reserve; the amount of the increase should, however, be less than the total financing required, with the remainder to be secured through efficiency savings. The extra financing should be conditional on BT's explicit acceptance of the need to achieve these savings. Following the meeting the Chancellor asked that the Policy Unit should let him have a note of any further points they wished to make by 2.30 p.m. on 1 April.

JW

A.J. WIGGINS
31 March 1981

Circulation:

Those present
Mr. Middleton
Mrs. Case
Mr. Norton

PRIME MINISTER

Nat Inc

Meeting with the Chancellor: Wednesday 1 April

I understand that the Chancellor wishes to discuss with you

(i) the timing of the Cabinet discussion of the ground rules for this year's PESC Review. This is bound to be a more controversial discussion than in previous years because of the new PESC system that we are introducing. In particular, colleagues will be asked to agree an inflation assumption for 1982/83 at this stage, and an assumption for pay for the same period (the Treasury are thinking of 6%). You have, I think, said that this discussion should be deferred until after Easter so as to give the Chancellor a little more distance from the Budget. However, the Treasury are pressing for a pre-Easter discussion because otherwise - so they argue - Departments will not have time to do the necessary work for a proper report to be prepared for Ministers before the summer recess. You will wish to judge the strength of this argument against the political risks of having another difficult Cabinet discussion before Easter.

(ii) Civil Service dispute. The Chancellor wishes to have a preliminary talk about Lord Soames' paper (Flag A), which is to be discussed at a meeting on Thursday morning.

You discussed with the Chancellor a fortnight ago his proposal that he should resume the Chairmanship of E(DL). You did not express a firm view. Robert Armstrong (Flag B) has now advised that it would be unwise to unseat Sir Keith - partly because the Treasury have scarcely speeded up privatisation, partly for personal reasons. We here agree with that advice. But John Hoskyns has suggested (Flag C) that there should be someone in the Treasury, Industry, or centrally with full-time responsibility for promoting privatisation, and also that David Young should be co-opted on to E(DL). You might put these two latter points to the Chancellor.

TL

31 March 1981

Ref. A04578

PRIME MINISTER

The Relationship between Government and Nationalised Industries

BACKGROUND

You are to hold an informal meeting next Tuesday with the Chancellor of the Exchequer, a few colleagues with responsibility for nationalised industries and Robin Ibbs to decide whether there should be a review of the relationships between Government and nationalised industries, and if so how best this should be organised. The basic text will be my minute to you of 13 March.

2. In discussion of an issue of this kind it would be very easy to devote a lot of time to substance, and a measure of this is perhaps inevitable. On the other hand the prime purpose of the meeting is operational. There is little doubt that colleagues will share your view that a rethink is necessary; the problem is how to organise it most effectively and expeditiously.

3. In paragraph 6 of my minute I set out the options and in paragraph 7 I recommend that the quickest and most effective is likely to be a study conducted by Robin Ibbs. Departments would of course be consulted in the course of the study but, to avoid bogging down in departmental in-fighting, Robin Ibbs should, I suggest, be personally responsible for his report and Departments should not be committed to its recommendations.

4. Whatever is decided about the nature of the inquiry, however, we need to set a tough timetable. Experience of the past two years has shown the devastating impact which unexpected calls for additional finance by nationalised industries can have on the totality of the Government strategy. As you enter the third year of your administration, you will want to be sure that everything is being done to reduce these risks. Of course major reform will inevitably take time to bear fruit. The greater the reason therefore for trying to get past the analytical and into the operational phase as quickly as possible.

5. As I said in my minute to you, this is well-tilled ground. The problems have exercised successive Governments, and Parliament, for over thirty years, and there is a wealth of material available to the investigators. The one big gap is perhaps an adequate analysis of precisely why the systems we now have in place have failed to produce, or to be recognised as providing, adequate warning of troubles ahead. This sort of area is pre-eminently one in which Robin Ibbs's industrial experience can make a big contribution. Subject to his view I would think it feasible to ask him to report within, say, three months. Any necessary action could then be put in hand before the summer recess and in time to begin to influence matters in the present financial year.

HANDLING

6. The best course might be for you to introduce the subject yourself and then to call on the Chancellor of the Exchequer, the other sponsoring Ministers and Robin Ibbs to make a contribution. The essential questions to be answered are:-

(a) How is the review to be conducted.

(b) When should the report be available for consideration by colleagues.

CONCLUSIONS

7. These will follow from the discussion.

RtA

ROBERT ARMSTRONG

27 March 1981

10 DOWNING STREET

MR. HOSKYNS
MR. YOUNG
MR. WOLFSON
MR. DUGUID
MR. STRAUSS
MR. LANKESTER

Some notes on the Treasury Paper by Croper are attached.

AAW

27 March 1981 ALAN WALTERS

NOTES ON MR. CROPPER'S PAPER ON FINANCING MORE INVESTMENT TO NATIONALISED INDUSTRIES

The argument of Mr. Cropper is essentially the standard one that additional investment by nationalised industries will cause the crowding out of either other private investment or private consumption (that is assuming that private consumption is unaffected). In the face of the standard Keynesian objection that there are large unemployed resources and in fact more public expenditure should simply see the absorption of additional unemployed factors into production, he gives something like a standard argument that it is likely the additional demand will be reflected in price inflation rather than in increased output. This is largely due to the rigidities in the economy caused by trade union practises, among other things. On financing, he says essentially that financing by means other than selling gilt edged will not help. It's the underlying reality that matters. What he is arguing is that no variations in financial arrangement will have any effect on that reality.

This is the normal Treasury position that there should be a complete divorce between the financing of public expenditure and the use of that expenditure. It is quite a different approach from that of business where the financing of a project or firm is often related to its particular needs. Indeed the self liquidating nature of many private financial operations is an essential counterpart to the reality of production schedules and cash flow arrangements.

The Treasury I think would argue that in theory the Treasury can always do better by having on the one hand a spending programme that is unfettered by financial constraints and on the other hand the freedom to raise cash from the market in a way that, subject to the constraints imposed by monetary policy, so that it can obtain the money as cheaply as possible.

I think, however, we should argue that the very divorce of finance and spending, which the Treasury defends so vehemently, is the source of many of our problems. What we should do is tailor our financial arrangments so that they match the reality of managerial decisions. (Indeed, I would suggest that one of the

main reasons why the programme of privatisation is so behind schedule is that there has been such a marked divorce between financial arrangements and managerial decision-making.)

One particular example is the Treasury objection to leasing arrangements. (The Treasury insists on the capitalised value of the lease as well as the payments in each year being debited against the EFL; this effectively precludes any nationalised industry adopting lease form of finance.) Yet clearly leasing has enormous advantages to a nationalised industry and can be used very efficiently. One example is that the nationalised industry can enter into not merely leasing contracts but also maintenance contracts with the supplying firms. Some arrangement of this kind is often a natural twin of leasing. I have seen this operate very effectively in the newly nationalised bus system in Bankok where they leased their buses and required the bus owners to maintain those buses on the road. The effective turnout of buses per diem was over 98%. The normal outturn in countries of this kind where there is no such leasing arrangement tends to be between 50% and 70%. The point is that the private sector adopts leasing arrangements and other forms of finance because they are efficient and it seems unlikely that the nationalised corporations could not improve their efficiency by adopting similar forms of finance.

Probably the most marked divergence between private finance and public is the fact that in any concern one would tailor the financial arrangements to the maturing obligations and cash flow of the operation. So far as I can see this is never done in nationalised industries. It seems rather silly for example to borrow 20-30 year money at extraordinarily high interest rates, at least compared with the Government's announced policy on inflation, when one need not get locked into such long term obligations. If the amortization programme of the nationalised industries allows for the amortization of debt in 5, 7 or 10 years, why not arrange one's borrowing accordingly? This, however, cannot be done.

Turning to the argument that the increase of public spending would increase the degree of inflation, one finds something of an inconsistency in the Government's spending policy. If, as Cropper

says, the problem is that spending will primarily generate trade union wage demands, as he may very well argue is the case in British Telecom, and will not absorb unused resources, then the whole spending policy of Government should be cast in terms of the trade union effect and effect due to any other rigidities which the Treasury have identified. Some consequences of this would be for instance that one should spend on road rather than railways because of the road haulage industry and probably also the road contracting industry is much less unionised than the railways. While I agree that there has been some policy moves in this direction, such as the small business incentive programme in the recent budget, one must admit that there is no systematic effort on the Treasury's part to identify those areas of expenditure where there is likely to be no rigidity encountered.

There are also a number of problems which are not addressed in the Cropper memorandum. The first clearly is that new forms of financing might be able to tap rather cheaply sources of finance which would otherwise not have gone into either private or public sector finance. He presumably thinks that the Treasury offer a wide enough variety of financed instruments to absorb any savers assets that he wishes to place in financial markets. Thus any new sort of instrument will only impoverish the proceeds of others. Perhaps so. But I cannot see why additional variety should be rejected, because at the very least it will not diminish the attraction of the instruments and, one never knows, it might just fill an undiscovered niche. We will never know unless we try. The main arguments for allowing British Telecom, Electricity and maybe Gas to issue their own debt or to tap savings of the household sector, is that they already have an established and computerised account with everyone, or at least virtually every household, in the country. The administrative costs then would be rather small, and I think far smaller than those of the existing national savings institutions. These do not have existing accounts with everyone in the country and consequently the administrative costs of additional accounts are very considerable. In the case of the utilities the additional cost would be quite small. Thus it seems likely that these methods may enable the acquisition of fairly cheap finance from the household sector.

27 March 1981

Ref: A04559

CONFIDENTIAL

MR. LANKESTER

Privatisation

Mr. Ian Gow wrote to Sir Keith Joseph on 20th March requesting briefing material on privatisation for a speech that the Prime Minister is to give on Saturday. It was subsequently agreed that the Cabinet Office would co-ordinate the preparations of this material before submitting it to you. I therefore attach in tabular form the material sought by Mr. Gow which has been prepared in co-operation with the Departments concerned and with the Treasury.

2. The material only includes privatisation measures that have been completed or that are already public knowledge. It does not include any new proposals for privatisation which have not yet been agreed. It also does not include details of the money likely to be involved in any projected privatisation measures. Although Departments have their own estimates of this, it would be undesirable for these to be revealed publicly at this stage: to do so could raise legal obstacles to a future sale and, in any case, Departmental estimates are subject to wide uncertainties. If the Prime Minister wishes to refer to the scale of proceeds from privatisation it might be preferable for her to use the global figures for 1979-80 and 1980-81 and the published target for 1981-82 set out after the tables.

3. Copies of this minute and of the enclosure go to the Private Secretaries to the Chancellor of the Exchequer, to the Secretaries of State for Industry, for the Environment, for Trade, for Energy and for Transport and to the Minister of Agriculture.

D. J. WRIGHT

(D. J. Wright)

27th March 1981

CONFIDENTIAL

ORGANISATION	DATE OF ANNOUNCEMENT	BRIEF DETAILS	LEGISLATION	APPROX. MONEY INVOLVED (£m)
MEASURES COMPLETED OR UNDERWAY				
BP	November 1979	Sale of 5% Government shares	-	280
National Enterprise Board	July 1979	Sale of NEB share-holdings	Enacted	120
Motorway Service Areas	22 October 1979	Sale of leases	Not required	50
British Aerospace	23 July 1979	Sale of 48% of shares to the public and of a further 4% to employees	Enacted	50 (excluding the cost of flotation - £4-5 million)
New Towns	1979	Sale of assets	Enacted	230 to date

Note: The figure of £120 million includes the proceeds of the sale of the NEB's shares in ICL. In view of the Government's recent decision to give ICL's bankers a guarantee, this figure requires careful handling.

ORGANISATION	DATE OF ANNOUNCEMENT	BRIEF DETAILS	LEGISLATION
MEASURES PLANNED			
British Airways	20 July 1979	Sale of shares announced in principle but no date set	
British Transport Docks Board	July 1980	49% sale of shares	In the House
British Rail subsidiaries	July 1980	Private capital to be introduced into major sub-sidiaries (Sealink and hotels) as soon as practicable	In the House
Cable and Wireless	March 1981	Sale of just under 50% of shares	BT Bill
National Freight Corporation	July 1979	Sale of shares	Enacted
The Radiochemical Centre	9 December 1980	Sale of shares announced in principle but no date or method set. Percentage to be sold to be decided.	In the House
Private electricity generation	21 July 1980	Removal of remaining prohibitions on private generation to enable electric-ity to be supplied as a main business	The Department of Energy hope to have a suit-able Bill next session
BNOC	February 1981	introduction of equity	In the House, but because of pressures on the Parliamentary timetable the Bill will need to be introduced next session

ORGANISATION	DATE OF ANNOUNCEMENT	BRIEF DETAILS	LEGISLATION
Heavy Goods vehicle and Public Service vehicle testing	December 1979	Disposal of testing stations and other assets	Hopefully next session
BSC	February 1981	BSC and GKN have announced their intention to combine their road and associated businesses into a new free-standing private sector company, "Allied Steel and Wire Ltd". This will reduce the size of BSC. It is hoped that other joint venture private sector companies will be established to take over BSC's activities in other sectors where there is an overlap of operations	The Iron and Steel Bill currently before the House

PROCEEDS FROM PRIVATISATION

The target of £1bn. for asset sales in 1979-80 was almost exactly achieved.

In 1980-81 proceeds are likely to total about £440 m.

The published disposals target for 1981-82 is £500 m.

CONFIDENTIAL

25 March 1981

MR LANKESTER

NATIONALISED INDUSTRIES : PRIVATISATION

1. We agree with Sir Robert Armstrong's view that changing the Chairmanship of E(DL) is unlikely to make much difference to progress on privatisation.

2. There are two other changes which we think are much more important:

(a) Somewhere - either at Treasury, Industry or centrally - someone needs to have full-time responsibility for promoting privatisation. This individual needs to be able to call upon a task force of others (some outsiders, some insiders) working part-time.

(b) The character of E(DL) would be improved by the addition of one or two individuals with wide commercial experience, on a regular basis. David Young would be one obvious candidate.

3. In our view, the will, competence and imagination necessary to drive through major changes like this simply cannot be generated by people working on the usual part-time basis.

JOHN HOSKYNS

cc A Dugg...

Ref: A04537

CONFIDENTIAL

MR. LANKESTER

Nationalised Industries: Privatisation

You asked me in your minute of 20th March to David Wright for advice on the Chancellor's proposal that he should now resume the Chairmanship of E(DL) in place of Sir Keith Joseph.

2. I think that it would be difficult to sustain the implication behind the last sentence of paragraph 10 of the Chancellor's minute, that the Secretary of State for Industry has been able to give less thrust to the work of E(DL) than the Chancellor was able to give. It is the Treasury, if any Department, that has tended to hold things up, and if the Treasury have new ideas there is nothing to prevent them to put them in and urge them on. It is difficult to believe that the Chancellor, with all the other pressures on him, has more time to give to this than the Secretary of State for Industry.

3. In the absence of strong arguments either way on the basis of efficiency in workload, it comes down to questions of personal relationships. I believe that the Secretary of State for Industry would take fairly hard the idea of giving up the chairmanship of E(DL): he might feel that he was being unfairly penalised for having had to propose additional help to BL, BSC, ICL etc. It would be easier to make a change in the context of some wider reorganisation and regrouping of the E sub-committees, either when decisions are taken on the relationship between Government and nationalised industries or perhaps after the Summer Recess when the new Session begins.

RetA

(Robert Armstrong)

24th March 1981

CONFIDENTIAL

CONFIDENTIAL

R H

Blind cc:- D Wright, CO
Mr Hoskyns
Mr Wolfson

10 DOWNING STREET

From the Private Secretary

20 March, 1981

The Prime Minister had a word with the Chancellor at their meeting on Wednesday about his minute of 10 March on Nationalised Industries' Privatisation. The Prime Minister did not express a firm view on his suggestion that he should resume the chairmanship of E(DL): I will be putting this back to her. But she agreed with the Chancellor that it would be a good idea to arrange a seminar to include the Ministers most directly concerned, one or two junior Ministers and some carefully chosen outsiders. She thought that it would be a good idea to include Sir William Barlow and David Young.

M. P. LANKESTER

A J Wiggins, Esq
HM Treasury

CONFIDENTIAL

CONFIDENTIAL

R H

BLIND CC Mr Hoskyns
Mr Wolfson

10 DOWNING STREET

From the Private Secretary

MR WRIGHT
CABINET OFFICE

NATIONALISED INDUSTRIES: PRIVATISATION

The Chancellor has minuted the Prime Minister suggesting that he should resume the chairmanship of E(DL) (I enclose a copy of his minute).

The Prime Minister and the Chancellor had a word about this at their weekly meeting on Wednesday, and the Prime Minister said she was inclined to go along with the suggestion. However, she did not give her firm endorsement, and I should be grateful for Sir Robert Armstrong's advice before a decision is taken.

On the face of it, the Chancellor's claim to resume the chairmanship does not seem overwhelming. My impression is that Sir Keith Joseph and his department have been trying to press ahead with privatisation in an imaginative way, and that the Treasury have tended to hold things up. Their role in the privatisation of British Aerospace and now their apparently negative attitude to the various proposals for bringing private capital in to the financing of British Telecom's investment programme are recent examples.

I have spoken to Sir Keith Joseph's office, and it seems that the Chancellor has not spoken to Sir Keith about this. If the Chancellor is to resume the chairmanship we would need to speak to Sir Keith first. I don't think he would take a change of chairmanship very well.

As regards the other proposal in the Chancellor's minute - i.e. that there should be a seminar on this subject to include some carefully chosen outsiders - the Prime Minister told the Chancellor that she thought this was a good idea.

T. P. LANKESTER

20 March, 1981

CONFIDENTIAL

With the Compliments
of the
Private Secretary
to the
Secretary of the Cabinet

C. A. Whitmore, Esq

Cabinet Office,
London, S.W.1.

1. Mr Lankester
2. PA.
Ind.
19:::

CABINET OFFICE

70 Whitehall. London SW1A 2AS Telephone 01-233 8319

From the Secretary of the Cabinet: Sir Robert Armstrong KCB, CVO

Ref: A04495

18th March 1981

The Relationship between Government and Nationalised Industries

I enclose a copy of a minute which Sir Robert Armstrong has sent to the Prime Minister suggesting a study of the relationship between the Government and the Nationalised Industries. The Prime Minister has said that she would now like to have a discussion of this subject with the Chancellor and the other Ministers mainly concerned, the Secretaries of State for Industry, for Energy and for Transport and has suggested that in advance of such a discussion they should see a copy of Sir Robert's minute. Copies of this letter and of the minute go therefore to the Private Secretaries to these three Secretaries of State. A copy of the letter also goes to Clive Whitmore.

D. J. WRIGHT

(D. J. Wright)

A. J. Wiggins, Esq

MANAGEMENT - IN CONFIDENCE

JH
see last 2 points
our note was obviously read.
Good!
KD.

NOTE FOR THE RECORD

cc. Mr. Walters
Mr. Hoskyns
Mr. Vereker

The Prime Minister had a meeting with the Chancellor at 1730 this evening. They discussed the following points:

(i) Appointments to the Treasury Select Committee

The Chancellor explained that Alan Budd and Harold Rose had resigned from their posts as advisers. The Committee had made some new appointments, and now nearly all the advisers were anti-Government. He would consider further how the sympathetic members of the Committee might be persuaded to have a more balanced team of advisers.

(ii) The Chancellor drew the Prime Minister's attention to the British Council of Churches' leaflet calling for a fast to oppose public expenditure cuts. He did not think Treasury Ministers could head this off; but someone must get the facts out. The Prime Minister said that Mr. Pym should be asked to do this.

(iii) Petrol Tax

The Chancellor said that he was making contingency plans against the possibility that the petrol tax would be defeated in Committee. But there were no obvious alternatives. The idea of increasing VED was unlikely to attract any more support than the existing petrol proposal. As a douceur, the Treasury were looking at competition amongst the petrol companies, and also the question of whether they might be discriminating against consumers in Scotland. The Prime Minister said that, whatever happened, the Treasury must claw back any lost revenue.

(iv) Civil Service Pay

The Chancellor said he was considering suspending 9,000 or so Inland Revenue personnel if they refused to undertake

/ work

work which would be thrown up by the stoppage of computers. The Government were now losing revenue at a rate of £425 million per month, and he judged that it might very soon be the right time to put pressure on the unions. Suspension of 9,000 would cost the union about £¾ million per week. If they were to strike, it would cost them rather more. He proposed to raise this in Cabinet tomorrow and the Prime Minister agreed.

(v) Water Manuals

The Chancellor reported that Mr. Prior had suggested that, in the wake of the water settlement, now might be the right time to consider the closed shop in the industry. Should he pursue Mr. Prior on this question? The Prime Minister said that on the whole it would be wiser not to for the moment.

(vi) Control of Nationalised Industries

The Chancellor referred to Robert Armstrong's recent minute, and suggested that the Treasury should be involved in the work which it proposed the CPRS should undertake. The Prime Minister said she had no objection to the Treasury being involved, but she wanted it to be quite clear that the CPRS would be in the lead. (This matter will be discussed at a meeting with the Ministers mainly concerned with the nationalised industries.)

(vii) Privatisation

The Chancellor referred to his minute of 10 March. The Prime Minister agreed with his suggestion that he should take over once again the Chairmanship of E(DL). (Afterwards, I told the Chancellor that I would need to pursue this with Robert Armstrong.) The Prime Minister also agreed that it would be sensible to hold a seminar for Ministers, officials, and one or two carefully chosen outsiders. She thought that David Young and Sir William Barlow would make a good contribution.

18 March 1981

10 DOWNING STREET

MISS STEPHENS

Please fix this up.
We need one hour within the next two weeks. Robert Armstrong, Robin Ibbs and John Hoskyns should also be invited please.

+ Peter le Cheminant.

TL

17 March 1981

Arranged for Tuesday
31 March at MOD.
1600.
No 10
ej.

bcc Hoskyns
Caroline S

FCS

Next Steps
Policy
Pictures

10 DOWNING STREET

From the Private Secretary

SIR ROBERT ARMSTRONG

The Relationship between Government and Nationalised Industries

The Prime Minister was most grateful for your minute of 13 March. She would now like to have a discussion with the Chancellor and the other Ministers mainly concerned (i.e. the Secretaries of State for Industry, for Energy and for Transport) as you suggest. She would be grateful if you would arrange for a copy of your minute to be sent to each of them.

T. P. LANKESTER

17 March 1981

Tim

17 March 1981

Policy Unit

PA

PRIME MINISTER

NATIONALISED INDUSTRIES: PRIVATISATION

1. Geoffrey's minute of 10 March proposed that we should move to a more radical phase in our basic policy of privatisation. We agree.

2. To achieve anything, a new impetus will be needed. We suspect that the Chancellor is right in arguing that a Treasury Chairman for E(DL) is the best way of challenging the objections of sponsor Ministers. But we also think that the character of E(DL) itself could be changed by the addition of one or two key outsiders. David Young would be one obvious candidate. It would not be difficult to suggest others.

3. We think Geoffrey's idea for an initial "brains trust" meeting is a good one. Once again, the presence of outsiders is an excellent idea: Sir William Barlow would be well-placed to tell us how things look from the position of an NI Chairman.

4. As Geoffrey says, this initiative would fit well with the proposals from Sir Robert Armstrong for CPRS work on relations with the industries that remain nationalised.

JOHN HOSKYNS

Ms Masters

cc Mr Ryrie
Mr Middleton
Mr Burgner
Mr Norton
Mrs Case
Mr Wicks
Mr Patterson
Mr G P Smith
Mr M Booth

Treasury Chambers, Parliament Street SW1P 3AG

The Rt Hon Sir Keith Joseph MP
Secretary of State
Department of Industry
Ashdown House
123 Victoria Street
London SW1

17 March 1981

NATIONALISED INDUSTRY FINANCIAL TARGETS - POST OFFICE

I understand that it is virtually certain that the Post Office will fail to meet its current financial target (set in the form of a 2% return on turnover after depreciation and interest) for 1980-81. Although intended to run for a 3-year period (1980-81 to 1982-83), the target needs to be achieved in each year in the 3-year period.

The financial target is of course a keystone in the financial framework between the Government and the nationalised industries. Despite the importance that we necessarily attach to the EFLs as a short-term cash control on the industries, the financial target remains the main expression of the financial performance which the Government intends the industries to achieve and which is a main determinant of their pricing and investment policy. Failure to meet it must therefore be regarded as a serious matter calling for a review of existing policies and practices and leading to remedial action. As a first step we need to decide what procedure to adopt when this occurs. There will no doubt be circumstances special to individual cases and I am not proposing immutable rules. However there are in my view some general points that should normally apply in each case.

First of all, we need to establish clearly why the industry has failed to meet its target. There should be a report by the sponsor Department on the basis of information from the industry and this should be agreed with the Treasury. This will not only be a post-mortem on the reasons for an unsatisfactory result but will propose the remedial action that needs to be taken. This may need to be followed up (depending on the circumstances) between the sponsor Minister and the industry Chairman. Second, there should be a Parliamentary announcement - on the lines of our current arrangements for EFLs - which would publicise the result and any remedial action that has been agreed. (Something of this

kind was done in the case of British Airways last year although what I am proposing goes further than this.) I suggest that this announcement could be timed with the publication of the industry's annual account following the year in question. The annual report should in any case contain details of the target and outturn in terms of the target. Nor would announcements be limited to cases where the industry has failed to meet the target. There should be similar publicity when a target has been met, so that a report of performance against target is seen as a matter of normal public accountability.

It would also be sensible in my view if progress in relation to target were explicitly discussed in the course of the annual Investment & Financing Review. This would offer an opportunity to take stock where as in the majority of cases the target period extends over a number of years.

If you agree that we should proceed along these lines, your Department will no doubt take steps to produce a report on the Post Office's failure to meet target in 1980-81 as soon as the facts are available; and propose remedial action.

I am copying this letter to the Ministers in charge of other nationalised industry sponsor Departments so that they may know of the general procedure proposed.

LEON BRITTAN

10 DOWNING STREET

Prime Minister

Here is Robert Armstrong's promised note on how we should proceed on the nationalised industries' problem. He recommends a CPRS study, and our Policy Unit (Flag A) support this. But he suggests first a discussion with the main colleagues concerned.

Shall we set this up?

Yes please

MT

16/3

16 March 1981
Policy Unit

PRIME MINISTER

GOVERNMENT/NATIONALISED INDUSTRIES RELATIONSHIP

1. We agree with Sir Robert Armstrong's proposal that CPRS should reappraise this relationship.

2. Our paper of 9 May 1980 on the lessons learned from the steel strike proposed that work like this should be carried out, preferably under CPRS leadership. Since then, some aspects of the NI problem have been examined in a rather piecemeal way but, as Sir Robert says, these studies have not gone to the heart of the matter.

3. More recently, our unpreparedness for the (predictable, in the context of union elections) muscle-flexing of the NUM shows how important it is to establish the right relationship with the nationalised industries - so that problems can be anticipated.

4. The relationships in question are not just those between Government and the NI Chairmen. Inside the Board, we need to think further about the balance of relationships: between executives and non-executives, for example - as suggested recently by Keith. And inside Government, we need to look again at the relationships between "sponsoring" Departments and others.

CPRS Priorities

5. We must recognise that CPRS is a very small resource: it cannot take on every difficult problem. But it is best-placed to take on this very important issue. Although their study would be primarily internal to Government, we think they should be encouraged to consult outsiders as well as Government Departments.

JOHN HOSKYNS

RESTRICTED

010 Nat Gnd Pts with C.A.W

NJS 6 sec

HP

VMS

DEPARTMENT OF HEALTH & SOCIAL SECURITY

Alexander Fleming House, Elephant & Castle, London SE1 6BY

Telephone 01-407 5522

From the Secretary of State for Social Services

The Rt Hon The Lord Soames CH GC MG GCVO CBE
Lord President of the Council
Civil Service Department
Whitehall
LONDON SW1

16 March 1981

Dear Christopher,

LEGISLATION ON PRIVATISATION ETC

I refer to Michael Heseltine's letter of 5 February suggesting that there should be a general Bill next session which would deal with the various changes that Ministers need to make following their reviews of quangos etc, and to your letters of 20 February and 2 March in which the suggestion has been developed in a rather different way.

In fact I share your own and Francis Pym's doubts about the feasibility of seeking general enabling powers designed to dispense with the normal process of repeal or amendment for quangos governed by primary legislation. But I do think the idea of a Government-wide Bill for the various fringe body changes that Ministers are committed to has considerable advantages. In my own field I need legislation to abolish the Child Care Advisory Council, the Food Hygiene Advisory Council and the Advisory Committee to the National Radiological Protection Board; and to amend the statutory constitution of the Central Council for Education and Training in Social Work. I have no doubt that other Ministers will have similar changes to make, which need early legislation. We made a considerable political point of the simplification of administrative procedures and the saving of manpower and expenditure that would result from the review of quangos; the onus is now on us to promote the legislation necessary to finish the job. I trust the proposal in your letter of 2 March might be developed to assist us in this.

Of course, a general Bill would have to be rather wide in scope. But there is an indirect precedent perhaps in the Public Expenditure and Receipts Act 1968, which amended the powers under which fees are levied in a variety of fields. And I would not expect this kind of Bill to be very controversial - the health and personal social services items would certainly not provoke much opposition. The material for these items is already drafted, having been prepared for the Health and Social Services Bill which we had planned for the present session. It consists of two clauses, though there are one of two small but useful other items (again already drafted) that I might wish to propose if the Bill were suitable.

E.R.

I am writing separately about the information needed about legislation for the 1981-1982 programme which will be necessary to achieve our manpower reductions.

I am sending copies of this letter to the Prime Minister, other members of the Cabinet, First Parliamentary Counsel and Sir Robert Armstrong.

Yours ever

Patrick

RESTRICTED

Ref. A04465

PRIME MINISTER

The Relationship between Government and Nationalised Industries

You told me after your lunch with Monsieur Thorn that you thought that the relationship between Government and nationalised industries was not at all satisfactory, and that we needed to rethink it. I had been thinking about how best to carry this forward, when you reverted to the point during the discussion of coal at the Ministerial Committee on Economic Strategy on 5th March.

2. Recent events have shown all too clearly that it is not possible, at any rate with the big loss-making industries, simply to rely on setting an external financing limit as an external discipline on the industries and in other respects to stand at arm's length from them. The EFL is essentially a residual: the difference between total cash outgoings and total cash income over the year, the forecasts of which can be thrown wildly out by relatively small changes on either side of the account. This problem is particularly acute in a time of recession, when demand upon an industry (and its income) can be very significantly lower than forecast. It seems that neither the industries themselves nor the Government have been very good at seeing those changes coming and adjusting forecasts in good time.

3. It seems that we need more effective internal monitoring procedures in the industries; more effective external monitoring procedures available to Government; and a more sophisticated and coherent approach in Government to the appraisal of nationalised industries' investment programmes.

4. Some relevant work is already in hand. The Chancellor of the Exchequer has been considering ideas for moving the nationalised industries towards the American pattern of commercially-owned and managed public utilities controlled by a regulatory system, and is on the point of proposing the establishment of a mixed group of Ministers and officials to pursue these ideas. The Treasury has been considering how to improve the system for Government appraisal of nationalised industries' investment. The Treasury and the CPRS have been

studying ideas for an efficiency audit of nationalised industries, which could be part of a process of external monitoring. The CPRS has already done some work on tighter monitoring of external financing limits, and has given thought to the responsibilities of members of nationalised industries boards.

5. None of these programmes, however, goes to the heart of the matter. Even if some of the nationalised industries could be turned into public utilities working within a regulatory system, that is a policy for the medium term: it would probably be 1982-83 at the earliest before it would be possible to introduce legislation. It seems likely that there would remain some industries which for one reason or another could not be transformed in this way and would have to remain in public ownership. And, if we are rethinking the relationship between Government and nationalised industries, proposals for efficiency audit of the industries are only part of the picture.

6. Successive Governments have grappled with this problem for the past 30 years. In 1968 the Select Committee on Nationalised Industries under Ian Mikardo proposed a Ministry of Nationalised Industries. There was an interdepartmental study in 1970-71. The CPRS under Lord Rothschild proposed a "flexible membrane" between the Government and industries at about the same time. And the NEDC proposed a Policy Council for each of the industries in 1976. So this is well-tilled ground. But the matter is so important that there is much to be said for another attempt to get relations with the nationalised industries on to a sound footing. What is needed is, I think, a fundamental reappraisal of the elements in the relationship and of what the role of the Government should be; and then, arguing from that, a consideration of what possible form of organisation would best give effect to that role. This will not of itself solve the problems that constitute the subject matter of relations between the Government and the nationalised industries; but it could well contribute to greater efficiency in identifying and clarifying the issues and possible solutions to them. I do not think that there is time to put this review out to some kind of external inquiry, which could take up to a year. As for internal inquiries, there are various possibilities:-

(i) The Chancellor of the Exchequer could be given the task of leading a study of this matter by Ministers and senior officials of the Departments concerned.

(ii) The Cabinet Office could be invited to lead a small group of senior officials from the Treasury, the sponsoring Departments and the CPRS in the preparation of an urgent study and report to Ministers.

(iii) The Head of the CPRS could be asked to consider what should be the basis of the relationship between Government and nationalised industries, and how best to give effect to that relationship so as to ensure a reasonable balance between the commercial responsibilities of the boards, and the supervisory responsibilities and financial commitments of the Government. The Treasury, the "sponsoring" Departments and the Policy Unit in No. 10 should be consulted in the preparation of the study, but Mr. Ibbs would be responsible for the report, and the Departments would not be committed. This report would be submitted to Ministers.

(iv) The Treasury at senior official level (in practice Mr. Ryrie) could be asked to take charge of the study, consulting the sponsoring Departments, the CPRS and the Policy Unit in No. 10. This would flow naturally from the Treasury's traditional responsibilities for general oversight and co-ordination of the financing of nationalised industries and the financial relationship between the Government and the nationalised industries.

7. My own recommendation would be for the third of these courses, a remit to Mr. Ibbs. I believe that it is likely to be quicker than any of the other courses; it is more likely to "think the unthinkable" and it is perhaps the most likely to produce the kind of paper which will set out the issues and the problems and possible solutions in a crisp and highly-focused form which will facilitate consideration and discussion by you and your colleagues.

8. The Chancellor of the Exchequer mentioned this problem to me the other day, as one we should need to tackle after the Budget; and I have had some discussion of the problem with Mr. Ryrie as well as with Mr. Ibbs. I have not

copied this minute to the Chancellor or to the other Ministers mainly concerned (the Secretaries of State for Industry, for Energy and for Transport); but the next step might be to discuss the matter with them, on the basis of this minute which could be copied to them if you agree.

RA

ROBERT ARMSTRONG

13th March, 1981

Prime Minister

The Chancellor wishes to discuss.

A

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

16/3

NATIONALISED INDUSTRIES: PRIVATISATION

My minute to you of 16 January identified extension of privatisation as the most helpful line of progress in dealing with the long-term problems of the nationalised industries. I also pointed out some of the difficulties, in particular the resistance to be expected from the industries themselves to proposals for radical structural change and the need for a strong and energetic commitment by the Government as a whole and individual sponsor Ministers. You asked me to consider how this work should be taken forward.

Present state of play

2. Considerable progress has been made through E(DL) in identifying candidates for privatisation, although not without a great deal of hard work. Both this session and last we have brought forward legislation and, in addition to BAe, we are preparing to float Cable and Wireless, British Transport Docks Board, National Freight Company and British Airways and to allow the private sector to take control of a number of British Rail subsidiaries, the Radiochemical Centre and some of British Telecommunications peripheral activities. The major need in this area is to press forward and take the final step of transfer to the private sector. The success of the BAe operation shows what can be done.

3. But looking further ahead, the position is less satisfactory. Apart from the decision yet to be taken on BNOC, there are no further immediate candidates in the shape of complete

/industries which

industries which can be floated off. There is further scope, however, for privatising parts of large industries where separate profit streams can be identified. For example, we are pressing for rapid progress on sale of BGC's oil assets and of its retail showrooms. Both the engineering workshop of British Rail and the Coal Board's open cast executive are being examined, as is the application of a similar approach to British Telecommunications. Something similar may be possible for British Shipbuilders once it is back on course and in the case of BSC, there are plans at various stages of development for privatising by means of joint ventures with private sector companies. These are being pushed ahead as far as possible. We are also examining the scope for privatising some Government trading fund operations including the Royal Ordnance Factories where the unfunded pension arrangements may cause considerable difficulties.

4. Bringing these schemes to fruition will demand determination and a firm resolve by the sponsor Ministers concerned. The problems encountered in pressing David Howell to get the Coal Board to sell a small builders' merchant subsidiary (Sankey Sheldon) and in his dealings with Sir Denis Rooke over BGC's oil interests give a taste of the difficulties we will encounter. Moreover, even with the maximum progress we will still be left with a significant nationalised sector imposing a large and unpredictable burden on the PSBR and remaining significantly sheltered from competitive forces.

5. We must develop plans for dealing with the remaining industries. One line of approach is to look for new ways of involving private sector capital and management in activities closely linked with some of the present nationalised industries. The boundary between public and private sector activities does not need to be as firm as it

/is now.

is now. This approach may be particularly relevant for industries whose mainstream activities are currently unprofitable, such as Rail, where it is difficult to believe that complete privatisation is realistic within the foreseeable future. We must avoid diverting management from their priority tasks and ensure that partial involvement of private capital does not impede or delay more radical moves. But I believe we need to look actively and urgently for areas of enterprise - enclaves - where private capital could operate in collaboration with the nationalised corporations with scope for profit and a degree of risk. The gains in terms of efficiency and innovation could be substantial. I know that Norman Fowler has been developing ideas of this kind. It is a matter of searching out possibilities industry by industry. I think we must put a new effort into this.

6. My main suggestion, however, is a more radical development of our basic policy of privatisation. I know we both agree that all our experience over the last year or two must force us to question whether the great utilities with their entrenched monopolies can be allowed to continue as they are in the public sector. We should not take it for granted that any industry, however basic or monopolistic or however essential the service it provides, should necessarily remain in public ownership. There are alternatives on the pattern of the United States and other countries where utilities are in the private sector but subject of course to public regulation, as well as some UK examples.

7. A related question is whether the utilities need retain the monolithic structure they have at present, whether within or without the public sector. Different organisational structures, licensing measures to increase competition, could help to produce greater pressure on the industries for efficiency.

/These are

8. These are not easy issues. Nor can we expect help in resolving them from the Chairmen, management or unions of the industries concerned. But I believe these are the issues we must now face.

9. How should we go about it? I am sure we have not yet reached the moment for a new initiative if by that is meant a major public announcement. That would only devalue the progress which has been made so far and arouse expectations about the future which we should not arouse until we are clearer how to advance. But if we are to break out of traditional preconceptions in Departments and among our colleagues as well as in the industries themselves, we need a new impetus internally. I very much hope you will feel able to give the proposals in this minute your full backing.

10. In the first place, we need to press forward to implement the proposals already identified in E(DL) and to develop others along similar lines. I hope that Keith Joseph, with the help of David Young, will be able to do this for Telecommunications and that others, including Norman Fowler, will press ahead also with ideas for involving private enterprise much more in activities in collaboration with nationalised industries. To help carry this forward I would like to suggest that I should resume the chair of E(DL). You will remember that I gave this up during the summer but experience since then suggests that it is easier for a Treasury Chairman to give the necessary thrust, harnessing the sources of information more easily available to a central Department to challenge the objections of sponsor Ministers.

Who is Chairman?

11. On the more radical questions about the large utilities, I think we need a new start. But we need to develop our ideas first. Should we consider privatising one or more of the large utilities? What kind of regulatory system would

/be required?

be required? What kind of moves could we be making to break up the monoliths and introduce more competition, hopefully as stepping-stones towards privatisation? Should we do best to spread our energies over a wide front? Or to concentrate on the most promising candidate industry (gas?) and press ahead with that.

12. One way to take our thinking forward on questions like these would be to arrange a brains trust or seminar including the Ministers most directly concerned with nationalised industries, David Howell, Norman Fowler and Keith Joseph, in addition to myself, together with perhaps one or two junior Ministers (John Moore and Norman Tebbitt, for example) two or three carefully chosen outsiders - and senior officials, of course. An alternative would be an ad hoc meeting of the same group of Ministers alone. Either way I should prepare a short paper proposing questions for discussion. The meeting should lead to a report which would be presented to you and considered by colleagues, perhaps in E Committee.

13. This approach should fit reasonably well with the new approach to our relations with the industries that remain nationalised, which I know you are considering and ought to make it possible to take some decisions about our next steps forward.

14. I hope these suggestions meet with your approval. We could perhaps discuss them at our next meeting.

(G.H.)
10 March 1981

6 March 1981

MR PATTISON

cc Mr Lankester

NATIONALISED INDUSTRIES

1. Your letter of 6 March to Ian Ellison refers to the Prime Minister's unwillingness to move on non-executive directors "at this stage, ahead of the wider issues of control of nationalised industries". The implication is that some wider work is going ahead on the subject of "control".

2. I don't think this is the case. The Prime Minister considered the much narrower issues of nationalised industry financing and privatisation recently and Tim's letter of 26 January to John Wiggins (attached for quick reference) conveys some views on these subjects.

3. I have spoken to the Treasury (Mrs Case) and CPRS (Mr Gibbs) and neither recognises a programme of work that fits this description - though of course issues of control arise peripherally in all work on NIs. I shall be discussing this further with CPRS on Wednesday morning. Before I do, are either of you aware of any other exercise looking specifically at the issue of control?

AD.

ANDREW DUGUID

Andrew

RTA Ian has been asked to do something - I have not Andrew.

Tim

I cannot trace any specific remit in this field, although PM seems to assume that something is happening. AD is looking at various pieces of work in hand which, together, might qualify. For you and he to pursue, I think?

MP 11/3

10 DOWNING STREET

From the Private Secretary

6 March 1981

I wrote to you on 22 February, following the recent exchanges about non-executive directors on nationalised industry boards.

The Prime Minister has given some further thought to this in the last few days, in the light of representations made to her. She does accept that there may be a case for providing a clearer framework for non-executive directors, but she is not ready to see this tackled at this stage ahead of the wider issues of control of nationalised industries. She is, nevertheless, prepared to come back to this topic in the context of the wider issue.

I am sending copies of this letter to Jim Buckley (Lord President's Office), John Wiggins (HM Treasury), Julian West (Department of Energy), Godfrey Robson (Scottish Office), John Craig (Welsh Office), David Edmonds (Department of the Environment), Stuart Hampson (Department of Trade), Anthony Mayer (Department of Transport), David Wright (Cabinet Office) and Gerry Spence (CPRS).

M. A. PATTISON

I.K.C. Ellison, Esq.,
Department of Industry.

FILE

10 DOWNING STREET

From the Private Secretary

MR. IBBS
CENTRAL POLICY REVIEW STAFF

The Prime Minister was grateful for your minute (QA 05262) about the role of non-executive directors in nationalised industries.

She agrees with your views about the control of nationalised industries: this is a point on which she has had some conversations in the light of recent events in the coal industry. She would, however, prefer to look at the wider problem first, before taking up the specific issues of non-executive directors in what might later seem to be a piecemeal fashion.

M. A. PATTISON

6 March 1981

PRIME MINISTER

c. Mr. Wolfson
Mr. Duguid

When you saw the earlier exchanges between Sir Keith Joseph and Lord Soames about non-executive directors, you expressed scepticism about Sir Keith's proposals to define more clearly their role. I reported this to them.

Mr. Ibbs has now come in, arguing that there is a case for a better defined framework. You may feel that his views, coming in so recently from industry, ought to carry some weight in this discussion. Would you like to ask him to pursue this with the Ministers concerned on your behalf, and to come back to you with suggestions?

MAD

I agree with Mr Ibbs about the control of non-executive directors - we had a brief discussion about it (when Sir Robert Armstrong) of the Cabinet dinner. But I think we

3 March 1981

Love to look at it with
Anthea first before any
private approach to non-members
decides to make.

N.B. - Do the rules debar
by relation?

MB

Qa 05262

To: PRIME MINISTER

From: J R IBBS

Role of Non-Executive Directors in Nationalised Industries

1. Mike Pattison's letter to Ian Ellison dated 23 February recorded your view to the effect that "if the right people are appointed, the rest will then take care of itself".

2. I feel I should let you know that my recent experience with BL, British Steel and other nationalised industries causes me to doubt this proposition. It may well be that some nationalised and state owned industries at present have inadequate non-executive directors; if so it may be some time before the introduction of new members of better quality can be relied on to correct the situation.

3. However, I believe that, even with the right people, there is a real risk that because the task is so ill-defined (and may in some respects differ from that of their counterparts in private industry) they may not invariably appreciate the right directions in which to deploy their efforts. For example, are they there to back the Chairman in pursuing a line based on "the best interests of the industry" which may amount to extracting all the cash he can from Government? Or do they also have some responsibility for pressing that the industry's policy should be compatible with certain wider (or perhaps more market-based) objectives? It is arguable that the more Ministers wish to stand back from nationalised industries, the more non-executive directors should be alert to any need to moderate the line being taken by the Chairman if he is, in Sir Keith Joseph's phrase, "captured by his industry". It may be that in a monopoly industry non-executive directors should be given special responsibility for being guardians of efficiency. As you know, I believe there is some parallel between non-executive directors in nationalised industries and those appointed in the private sector to 100 per cent owned subsidiaries. In the latter case it would be quite normal for them to be given a very clear idea of what the shareholder wanted.

4. The control of nationalised industries and their Chairmen seems to me far from satisfactory at present and the non-executive director is potentially a way of improving this (although certainly not the only way and perhaps not the main one). At least until the overall control of nationalised industries has been improved, I suggest it is right to explore ways in which some specific clarification of the role of non-executive directors might be helpful.

5. I am sending a copy of this minute to Sir Robert Armstrong.

3 March 1981

PART 3 ends:-

~~Hbs~~ to Ind of 23/2/87

PART 4 begins:-

Hbs to PM (Qa 05262) of 3/3/87.