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CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

NATIONALISED INDUSTRIES EXTERNAL FINANCING LIMITS 1981-82 AND FINANCING REQUIREMENTS IN THE LATER YEARS (1982-83 AND 1983-84)

Note by the Chief Secretary, Treasury

We agreed in July to set external financing limits (EFLs) for the industries in the autumn in order to exert the maximum influence on pay negotiations. We also endorsed a timetable under which EFLs would be announced in November. Sponsor Ministers will need to secure the industries' acceptance of the EFLs before this. Decisions on EFLs are needed to meet that timetable and, more urgently still, provisional decisions are needed now as an input to Cabinet's consideration of the public expenditure totals.

Public Expenditure Position

2. The financing requirements foreseen by the industries have increased significantly over the past four months:

(i) In July we agreed that an additional £470m (at 1980 Survey prices) should be provided towards the nationalised industries' requirements to be offset by savings on other programmes.

(ii) On 17 September this Committee discussed a further increase of £413m in the requirements of the major loss makers, primarily steel, and we agreed that this should be absorbed by the industries themselves. Discussions with colleagues on how the savings should be achieved identified specific proposals to absorb only about £40 million of the expected £413m excess. However, the discussions were overtaken by the industries' bids for their 1981-82 EFLs.

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(iii) In late September and early October the industries submitted their 1981-82 EFL bids reflecting up to date forecasts of the impact of the recession and its consequences. These (set out in Annex A, Column 1) implied a very substantial further increase in their aggregate financing needs amounting in total to an increase over the £470m agreed in July of almost £1.3bn.

3. Following discussion with the industries and sponsor Departments, the Treasury has assessed the scope for savings on the original bids. The outcome is set out in Annex A, Column 2. Annex B prepared by Treasury officials sets out and comments on the basis for the figures in Column 2 which the industries and sponsor Departments concerned do not in all cases accept. There are no firm figures for BSC and no provision is made for BAe on the assumption of a sale in 1980-81.

4. The figures in Column 2 of Annex A are some £1 billion in cash below the orginal bids. The savings have been found on current costs, including revised pay assumptions, and from cutbacks in capital investment which for some industries are substantial. They also mean earlier or higher price increases (notably for gas and telecomms). Even so, deflated by a consistent factor, they remain £500 million in 1980 Survey prices above the provision for the industries agreed in July.

Economic Assumptions and Pay

5. Setting EFLs is a more complex process than setting normal cash limits. Because they are the difference between much larger flows of revenue and expenditure of trading organisations, they cannot be set in a mechanical way if they are to be realistic yet exert adequate discipline. E(NF) Committee agreed that the approach to setting EFLs should be that agreed with the Chairmen in the summer (as set out in the Chancellor's 4 August statement) and should take account of our public expenditure decisions, the industries' revised financing forecasts, our own economic forecasts and our view of

appropriate pay assumptions. We will also need to ensure that the outcome can be defended as compatible with the RSG cash limit and other cash limit factors to be announced at the same time.

6. As foreshadowed in my paper on the IFR in July, E(80)64, the assumptions made by the industries in their IFR forecasts have been revised. Even so, their GDP assumptions for the two years from 1979 to 1981 may still be optimistic and this is only partly offset by their somewhat pessimistic inflation assumptions. Officials have not sought to influence these assumptions. The industries set considerable store by using their own assumptions and, in our present difficult PSBR and public expenditure situation, it is clearly right to accept the risk involved of later breaches.

7. The industries' original pay assumptions were in many cases clearly inconsistent with our decision in July to set EFLs on tight pay assumptions. Very few industries were assuming increases in earnings at or below 10 per cent, the majority were in the 12-15 per cent range in line with their inflation expectations with BGC at 17 per cent still higher. These assumptions have been "talked down" by officials in discussing the EFL bids without of course blessing any particular figure. This has provided a welcome contribution to reducing the bids in total. With one exception (BAA), the industries are now assuming 11% or less for settlements in the wage round ending 31 July 1981 with the majority including gas, electricity, telecomms, NBC, BTDB aiming at 10 per cent or less. (There is no specific assumption for the NCB whose 1981-82 EFL has already been set.) This is still not ideal but could just be presented as compatible with the Government's approach to public sector pay and as broadly matching the expected level in private sector manufacturing industry.

8. To reduce the pay assumptions further would mean cutting some EFLs by an amount equal to the remaining "excessive" element in their assumptions. There would be a row with the Chairmen involved and a serious risk that the chosen figure would come to be represented

as a norm, unless it could be wrapped up as an arbitrary EFL reduction for public expenditure and PSBR reasons. Given the limited number of cases where a settlement over 10 per cent is now assumed, the limited savings that would accrue from their reduction to that level and the indirect bearing of the EFL discipline on pay, there seems little to be gained from squeezing pay assumptions further.

The Level of EFLs for 1981-82

9. As a first step we must clearly agree to secure the savings underlying the figures in Column 2. But we cannot rest there. The industries' external financing requirements would remain some £500 million above the level agreed in July and this poses an important problem in relation to our agreed public expenditure aims. Even though further cuts will be difficult and painful, it seems right, as we agreed in September, that the industries should make a further contribution to offsetting that excess. A cut equivalent to 10 per cent of the investment levels proposed in the IFR would be needed to recoup the full £500 million. I believe we must aim to secure at least £200 million towards this.

10. There are two alternative approaches to this:

(i) an across the board cut in each industry's financing requirement (as set out in Annex A, Column 2) equivalent to 4 per cent of the proposed level of fixed investment in the IFR attached to my paper E(80)64; or

(ii) selective cuts in the requirements set out in Annex A Column 2 for those industries whose programmes may be in a better position to meet this, with no cuts below the Annex A, Column 2 figures for the remaining industries. I propose the following package of selective cuts which would yield about £200m:

	£ million At Survey prices
Electricity Council and Boards - investment cut The industry has already reduced its investment programme but the CEGB have a margin of spare capacity and deferrals of new station construction should not lead to electricity supply shortages.	60
PO Telecomms - investment cut This is a large and important programme but the industry are bidding for a significant increase. The cut suggested would still leave their programme above the Cmnd 7841 level.	60
Sale of 2m tonnes of coal stocks abroad by CEGB CEGB coal stocks are likely to be at high levels as a result of lower electricity demand and ought not to bring stocks below levels which the Board would regard as commercially desirable.	60
British Rail - cut in financing requirement from investment or elsewhere. The industry have the biggest EFR with a large grant component.	25

I ask the Committee to decide which approach is to be adopted.

Procedure

11. Once we have agreed on the EFLs, their presentation to the industries will be very important. In talking to the Chairmen, sponsor Ministers will need to represent the reduced figures as the industries' inevitable contribution to a difficult macr-economic situation. The Chairmen should be reminded that they have always accepted that EFLs might be cut on this score.

1982-83 and 1983-84

12. In the time available I have not discussed in detail with my colleages how to achieve the savings necessary in the later years to meet E Committee's decision that the industries' additional bids in the later years should also be met by economies in the nationalised industry sector. We need to do this as soon as possible in order to give the industries the expected indication of the later year figures for planning purposes. But it is essential that we should keep the later year figures within the totals agreed in July

even though revised forecasts eg, from BGC suggest that the industries' forecasts for these years should also be increased to reflect greater pessimism about the economic prospects.

Recommendation

13. To enable me to report to Cabinet on the public expenditure position, I invite the Committee

(i) to confirm the reductions in Annex A, Column 2;

(ii) to decide which of the approaches in paragraph 10 should be adopted in setting 1981-82 EFLs for the nationalised industries and to agree to set 1981-82 EFLs on that basis;

(iii) to agree the approach in paragraph 12 above for the later years.

W.J.B.

Treasury Chambers
Parliament Street
SW1

17 October 1980

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Recommendation

13. To enable me to report to Cabinet on the public expenditure position, I invite the Committee

(i) to confirm the reductions in Annex A, Column 2;

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(iii) to agree the approach in paragraph 12 above for the later years.

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Treasury Chambers
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ANNEX A

EXTERNAL FINANCING LIMITS 1981-82

£m at outturn prices

	Original Bids (Col 1)	Suggested Outcome Without Further Policy Decisions (Col 2)
National Coal Board	882	882
Electricity Council and Boards	-221	-221
North of Scotland Hydro-Electric Board	+ 34	108
South of Scotland Hydro-Electric Board	+ 87	
British Gas Corporation	- 99	-399
British National Oil Corporation[1]	-323	-360
British Steel Corporation[2]	[670]	[670]
Post Office - Telecomms	738	300
Posts and Giro	53	24
British Airways Board	154	125
British Airports Authority	35	16
British Railways Board	1025	888
British Transport Docks Board	- 5	- 9
British Waterways Board	35	31
National Freight Corporation	19	15
National Bus Company	80	76
Scottish Transport Group	18	18
British Aerospace[3]	-	-
British Shipbuilders	153	153
TOTAL	3335	2317
Equivalent at 1980 SP	2490	1730
Change on proposals in C(80)40	+1270	+500

1 BNOC are not set a formal EFL

2 Figures not yet firm

3 No EFL on assumption of privatisation before 1981-82

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122
123
124

NATIONAL COAL BOARD

External Finance	£m 1980 Survey Prices 1981-82
1. Cmnd 7841 revalued*	658
2. IFR bid/E(80)64	658
3. IFR baseline after changes agreed in bilateral	658
4. EFL‡	658 (882 outturn)
5. Reduction required to achieve cut equivalent to a 10% cut in investment programme	-70

* Adjusted for subsequent Ministerial decisions.

‡ The EFL has already been set at £882m (outturn), subject to the proviso mentioned in paragraph 2 below.

E Committee agreed on 15 September that the external financing requirements for the NCB over the Survey period should be at the volume levels agreed last year as part of the Financial Strategy for the industry.

2. Treasury Ministers have agreed that the NCB's EFL for 1981-82 should be derived by revaluing the Survey Price external financing figure for 1981-82, set in the industry's Financial Strategy, by the standard index for converting Survey figures to outturn prices. This gives an EFL of £882m in outturn prices. The Chancellor has also insisted (in his letter of 13 October to the Secretary of State for Energy) that the option should be kept open of seeking a cut in the EFL of £882m, if this is necessary to help deal with any excess in the nationalised industries' EFLs generally. The Board are being informed of the EFL, and of this proviso.

3. An EFL of £882m will be tight and the Board are likely to have to make substantial investment cuts in order to meet it.

ELECTRICITY SUPPLY INDUSTRY (ENGLAND AND WALES)

External Finance	£m 1980 Survey Prices 1980-81
1. Cmnd 7841 revalued (for comparison)	-8
2. IFR bid/E(80)64	-232*
3. Following bilateral	-232
4. EFL bid by industry‡	-165 (-221 outturn)
5. Amended bid before cuts in line 6 (ie no change from line 4)	-165 (-221 outturn)
6. A cut equivalent to 10% of the industry's investment	-90

* Reflects cut of £16m already made in respect of Cross Channel Link.

‡ The bid has been put forward, without commitment on a provisional basis, by officials of the Electricity Council. The Council will consider it on 16 October and may take decisions (eg asking for a lower financial target) which result in a higher bid.

Assumptions Underlying EFL Bid (line 4)

GDP Growth: 3.0% fall between 1979-80 and 1980-81; nil in 1981-82

Inflation : March 1981 to March 1982: 13%

Pay : Settlement of 10% (9.3% on wages and salaries bill in 1981-82)

Tariff Increases: 18½% on 1 April 1981; it could be 2-3% less if fossil fuel prices rise slower than the industry has implied in their EFL bid.

2. The IFR bid is lower than Cmnd 7841 largely because of the setting of financial target, implying higher tariffs and internal resources. There is also a reduction in forecast CEGB capital spend. The EFL bid is higher than the IFR baseline largely because of lower sales forecasts.

3. There are no obvious grounds for querying the industry's bid on the basis of present policies or the assumptions stated.

4. A cut in the EFL bid equivalent to 10 per cent of the industry's investment could be achieved by:

i) An increase in electricity tariffs of some 2 per cent above the levels implied in the EFL. The industry would strongly resist such an increase and may argue that it would bring tariffs above long run marginal cost.

ii) A reduction in coal stocks of some 3m tonnes (though this would be at the expense of the NCB's EFL unless the CEGB backed off imports).

iii) Cuts in capital investment, including the deferment of work on one or more of the CEGB's stations now under construction, almost certainly including the new Heysham II AGR station. There would need to be detailed discussions with the CEGB to establish the feasibility of the cut (eg that penalty payments for cancelled contracts do not absorb savings from the deferment). The Department of Energy say that deferment of Heysham II would call into question the credibility of the Government's nuclear policy. They say that it would also have severe repercussions for the power plant industry, possibly jeopardising our ability to build similar power stations in the future, and would very probably involve a similar deferment of the SSEB's AGR station at Torness.

External Finance	SSEB	NSHEB	Total
			£m 1980 Survey Prices
1. Cmnd 7841 revalued (for comparison)	77	15	92
2. IFR bid/E(80)64	65	27	92
3. IFR bid after changes agreed in bilateral	58	24	82
4. EFL bids by industry‡	65 (87 outturn)	26 (34 outturn)	91 (121 outturn)
5. Amended bid before cuts in line 6*	58 (78 outturn)	23 (30 outturn)	81 (108 outturn)
6. Reduction required to achieve cuts equivalent to a 10% cut in investment programme	-19	-4	-23

‡ The Boards have not submitted a formal bid; the figures in line 4 reflect the "central assumption" of a tariff increase roughly in line with inflation.

* Breakdown between the two Boards remains tentative at this stage.

<u>Assumptions Underlying EFL Bid (lines 4 and 5)</u>

GDP Growth: -2% in 1980; +0.5% in 1981

Inflation : March 1980 to March 1981: ;5%
March 1981 to March 1982: 12%

Pay : 15% in line 4, but following bilateral, figures in line 5 assume pay settlement of 10% (in line with electricity industry in England and Wales)

Tariff Increase : A working assumption of 15% on 1 April 1981.

2. There are no obvious grounds for querying the industry's bid on the basis of present policies or the assumptions stated.

3. A cut equivalent to 10 per cent of the industry's investment could be achieved by:

i) A saving of about half the £23m could be obtained by an increase in electricity tariffs of some 3 per cent above the 15 per cent level implied in the EFL in line 4 above, bringing the tariff increase close to the 18½ per cent assumed in the provisional bid by the electricity supply industry in England and Wales. The two Scottish Boards would most strongly resist such an increase, would be likely to say that it was publicly foisted upon them by the Government and would argue that it had no economic justification.

ii) Further cuts in capital investment, the scope for which the Scottish Office say is confined to the deferment of work on the SSEB's new AGR station now under construction at Torness. There would need to be detailed discussions with the SSEB to establish the feasibility of the cut (eg the penalty payments for cancelled contracts do not absorb savings from deferment). Deferment of Torness would have severe repercussions for the power plant industry and would be acceptable to the SSEB only if there was a similar deferment of the CEGB's AGR station at Heysham.

4. In any event the Treasury believe that there would be difficulties if tariffs in Scotland (which are already lower than in England and Wales) did not rise in line with those in England and Wales. Final decisions on the Boards' EFLs should therefore, in the view of the Treasury, be taken in the light of decisions on the EFL for the electricity supply industry in England and Wales.

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BRITISH GAS CORPORATION

£m 1980 Survey Prices

External Finance

		1981-82
1.	Cmnd 7841 revalued (for comparison)	-307
2.	IFR bid/E(80)64	-368*
3.	Following bilateral	-368*
4.	EFL bid by industry(paras 3-5 below)	-74 (-99 outturn)
5.	Amended bid before cuts in line 6	-298 (-399 outturn)
6.	A cut equivalent to 10% of the industry's investment figure	-63

* Figure adjusted for a £15m provision for gas gathering pipeline.

Assumptions Underlying EFL Bid (line 4)

Inflation : 1981-82 on 1980-81: 14%

Earnings Increase : 17%

Contract gas renewal price: 31.0 p/therm firm contract, 24.5 p/therm interruptible, from 1 July 1981

Exchange Rate: Smithsonian index: 67

Tariff Increase : Domestic 15% 1 April 1981, 10% October 1981; Non-domestic 3%, 1 October 1981

Assumptions Underlying Treasury Proposal (line 5)

All as above except for

Earnings Increase : See paragraph 3 below

Tariff Increase : See paragraphs 4 and 5 below.

2. The IFR bid figure represents an improvement of £61m on Cmnd 7841 due to a combination of lower working capital requirements and an increase in forecast internal resources offset by a slight increase of £12m in the requirement for fixed assets. The £294m increase in the EFL bid on the IFR bid reflects a significant (£414m) forecast fall in internal resources partially offset by a considerable reduction in the requirement for fixed assets (£63m), and working capital (£57m).

3. Discussions with BGC have indicated that their original EFL bid can be reduced by £185m (outturn) by the following measures:

	£m (outturn)
Higher sales of interruptible gas	60
Earnings assumption at 10%	60
Reductions in fixed investment, including on Morecambe Phase II	50
Higher contribution from appliance market activities	15
	185.

All these measures are well justified on their merits.

4. Other measures put forward by BGC for reducing their EFL are:

	£m (outturn)
Adjustments to the non-domestic tariff	5
Larger increases in the price for firm contract gas for industry consumers (quarterly escalation of 1p)	20
Either	
Increase in domestic gas prices of 27% in April 1981. This reflects the already announced 10% real increase based on the Corporation's assessment of a 17% year on year RPI increase in December 1980 (the date by which they should take decisions on the April price increase)	90
OR	
A 17% increase based on the assumption above on 1 April 1981 and a further 10% increase on 1 October	30
	55-115

5. The measures in paragraph 3 and 4 together would reduce the EFL bid by £300m making it -£399m in outturn prices, assuming the 27% increase in domestic gas prices in April 1981.

6. The Department of Energy have reserved their Secretary of State's position on the amended EFL referred to in line 6 of paragraph 1.

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BRITISH NATIONAL OIL CORPORATION

External Finance	£m 1980 Survey Prices 1981-82
1. Cmnd 7841 revalued (for comparison)	-398*
2. IFR bid/E(80)64	-356*
3. Following bilateral	-356*
4. EFR bid by industry	-241 (-323 outturn)
5. Amended bid before cuts in line 6	-269 (-360 outturn)
6. A cut equivalent to 10% of the industry's investment figure	-24

* Figures adjusted for changes in assumption about notional dividend payments.

(BNOC are not set an external financing limit because most, but not all, of the Corporation's expenditure is outwith its control and its revenues reflect the level of oil prices and partners' decisions on production. The Corporation are, however, given an external financing requirement (EFR) within which they are expected to conduct their business.)

Assumptions Underlying EFR Bid (lines 4 and 5)

Inflation: mid 1981-82 on mid 1980-81: 15%

Exchange rate : $2.40/£

Oil Price: $37.00/barrel 1981-82 Q1-Q3; $40.70/barrel Q4

Earnings Increase: BNOC's salaries are a very small part of their expenditure and the Corporation do not make a specific assumption about salary rises which simply form part of their general and administrative expenditure. They assume this will rise by 14%.

2. The IFR bid is worse than Cmnd 7841 largdy because of a reduction in forecast revenues. The EFR bid is worse than the IFR bid because of assumptions about a higher exchange rate and lower oil production.

3. The Treasury believe that it should be possible to reduce BNOC's EFR bid to -£269m (-£360m outturn) to reflect the cut in the Corporation's provision for "unspecified expenditure" (eg for contingencies, farm ins etc), a five-year delay in the Clyde oil field and other minor estimating changes. This would imply fixed investment

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broadly in the region of £300m in outturn prices; the Treasury suggest that the precise figure should be agreed bilaterally between the Chief Secretary and the Secretary of State for Energy after the external financing requirement has been fixed. The Department have reserved their Secretary of State's position on the external financing requirement.

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External Finance	£m 1980 Survey prices 1981-82
1. Cmnd 7841 revalued (for comparison)	+ 83
2. IFR bid - E(80)64	+165
3. Following bilateral	+165
4. EFL bid	+555 (+738 outturn)
5. Amended bid (before cuts in line 6)	+225 (+300 outturn)
6. Cut equivalent to 10% of the industry's investment figure	+ 75

Assumptions underlying EFL bid (line 4)

GDP Growth: - 2½% (79-81)

RPI : +15% (80-81 to 81-82)

Pay : 11% settlement. Earnings:
15% increase financial year on financial year
12% increase settlement year on settlement year

The Telecomms bid in the IFR compares with provision in Cmnd 7841 of £83m, the proposed addition being mainly for investment in fixed assets - System X, Prestel, etc. The outcome of the bilateral was inderminate: the Secretary of State for Industry undertook to discuss the possibility of reductions with the industry against the benchmark of a sum equivalent to 8% of their investment programme (£120m). The EFL bid (line 4) reflects changed estimates of inflation and stock levels, the effects of payments already deferred from last year, a request for further investment in System X, and the interest costs associated with a higher level of borrowing.

2. Discussions with Telecomms and the Department of Industry have indicated that the Telecomms EFL bid can be reduced by £330m by the following measures:

	£m at Survey Prices
10% tariff increases in autumn 1981	170
Deferring payments into 1982-83	110
Deferment of new investment bid	35
Reduced estimate of interest costs	15
	330

3. A 10% cut in Telecomms' investment programme would yield

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£150 million savings, leaving a planned investment level lower than that provided for in Cmnd 7841. This would involve:

- delaying the introduction of System X;

- delaying the introduction of new products and services such as Prestel and Teletex and the modernisation of existing ones;

- deferring expenditure to reduce waiting lists.

External finance	£m 1980 Survey prices 1981-82
1. Cmnd 7841 revalued (for comparison)	-16
2. IFR bid - E(80)64	+ 3
3. Following bilateral	+ 3
4. EFL bid	+40 (+53 outturn)
5. Amended bid (before cuts in line 6)	+13 (+24 outturn)
6. Cut equivalent to 10% of the industry's investment figure	+ 9

Assumptions underlying EFL bid (line 4)

GDP growth	:	- 2½% (79-81)
RPI	:	+15% (80/81 to 81/82)
Pay	:	10% settlement (12% earnings increase)
Tariff increase	:	Financial target likely to require 15%, 1 October 1981

The IFR figure (+3) is £19m above the provision for Posts and Giro in Cmnd 7841, mainly reflecting a reduced estimate of internal resources in face of the declining economic position. The EFL bid (line 4) reflects changed estimates of inflation since the IFR and a request for additional investment for Post's mechanisation programme.

2. Discussions with Posts and the Department of Industry have indicated that the Posts and Giro EFL bid can be reduced by £22m by the following measures:

	£m at Survey prices
Deferment of additional investment	9
8% cut in investment programme	8
Additional planned disposals	3
Reduced RPI assumptions	2
	22

3. No significant further action is contemplated by the industry to reduce its EFR. The Treasury and the Department are satisifed that the amended bid is a reasonable assessment of Posts/Giro EFR on the assumption that financial targets are achieved. The CST's request for an 8% reduction in investment volume has been met in full, and the industry is convinced that lower pay assumptions

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would be unrealistic. The achievement of Post's financial target, in the absence of major economies is likely to require tariff increases of at least 15% next autumn.

5. A further 10% investment cut would reduce the amended EFL bid by £9m, leaving alevel of fixed investment still in excess of that planned in Cmnd 7841. The main effects would be further delay in Post's mechanisation programme and hence a lower level of efficiency.

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BRITISH AIRWAYS

External Finance

	£m 1980 Survey Prices 1981-82
1. Cmnd 7841 revalued (for comparison)	106
2. IFR bid/E(80)64	96
3. Following bilateral	96
4. EFL bid	115 (154 outturn)
5. Amended bid before changes in line 6	93 (125 outturn)
6. A cut equivalent to 10% of the industry's investment programme	22

Assumptions Underlying EFL Bid (line 4)

UK GDP Growth: 1979-81: -3%

Inflation : 1981-82 on 1980-81: 15%

Wage Settlement : 12% of pay bill (earnings: 10% award plus 2% drift etc)

Staff Numbers: -6.6%

Exchange Rate: £1 = $2.25

Fuel Price : +5% real increase

Average Interest Rates (US) : 11½%

2. British Airways volume figures have been revised upwards during the IFR discussions (and then reduced at the bilateral) as their operating environment deteriorated. Their EFL bid reflects reductions in capital expenditure to offset forecast lower internal resources. The amended bid is slightly below that indicated by the volume figures since BA assumed a slightly lower deflator. Both assume agreement on Boeing 747 financing arrangement.

3. BA's EFL bid assumes an airline cash operating profit of £50m and capital expenditure of £300m (of which over 90 per cent is already contractually committed). BA's assumptions on exchange rate, fuel price, interest rate and inflation are all on the pessimistic side, but on the other hand, traffic volume and yield are still very uncertain and forecast internal resources may be optimistic. Capital

expenditure figures assume no new aircraft orders placed, but take little account of possible asset disposals (both aircraft and others).

4. On balance the cash bid appears reasonable (although British Airways are concerned that it may be too tight) but it should be recognised that BA's future flexibility will depend partly on asset disposal decisions needed to remain within the current year's EFL. BA have been unable to offer any other concrete measures for reducing their EFL and although they intend to try to keep their pay increase below 10 per cent, they are not optimistic about success.

5. BA would claim that they could not live with a cut equivalent to 10 per cent of their investment programme, particularly since most of the capital expenditure is already committed. However, the Treasury believes that there is still further scope for deferral or disposal of aircraft, disposal of non-mainstream assets and operating cost savings by route rationalisations.

BRITISH AIRPORTS AUTHORITY

£m 1980 Survey Prices

External Finance

	1981-82
1. Cmnd 7841 revalued (for comparison)	0
2. IFR bid/E(80)64	26
3. Following bilateral	16
4. EFL bid	26 (35 outturn)
5. Amended bid before changes in line 6	12 (16 outturn)
6. A cut equivalent to 10% of the industry's investment programme	9

Assumptions Underlying EFL Bid (line 4)

UK GDP Growth: 1979-81: -1.3%

UK Inflation Rate : March 1982 on March 1981: 12%

Wage Settlement : 14% of pay bill (1981 calendar year settlement: 12%) (1982 calendar year settlement: 15%)

Staff Numbers: -8%

Tariff Increase : average increase in landing fees from April 1981 in line with inflation

2. The proposed EFL of £12m (£16m cash) is lower than BAA's own bid of £26m (£35m cash) partly because of a £10m reduction agreed at the bilateral. BAA's original IFR bid had assumed that landing fees would be increased from April 1981 by inflation plus 5 per cent in order to achieve their financial target. In their EFL bid BAA have revised that assumption downwards to an increase only in line with inflation. This might not be sufficient to achieve their financial target, but they believe more realistic in view of the current legal battle with the airlines over these fees. This difference accounting for £4m (£5m cash) has been deducted by the Treasury from their bid, as it represents an assumption at variance with achieving the agreed financial target. The Department of Trade strongly disputes this deduction.

3. In other respects the bid appears reasonable, although the high level of fixed costs makes the internal resources forecast very

sensitive to volume changes. However, the profits of peripheral activities such as duty-free sales which have recently been revised downwards, may increase if the exchange rate weakens and/or alcohol and tobacco duty is increased. Although they intend to try, BAA do not believe it will prove possible to keep their pay settlement increase to single figures in view of the relatively low settlement achieved in the current year.

4. BAA have not been able to put forward any other measures for reducing their EFL as considerable cost reductions have already been assumed and they claim to have pared down their capital expenditure to a minimum.

5. BAA would claim that an imposed further cut of 10 per cent of their investment programme would seriously delay construction of either Heathrow Terminal 4 or Gatwick Terminal 2.

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BRITISH RAILWAYS BOARD

£m 1980 Survey prices

External Finance

1.	Cmnd 7841 revalued	623
2.	IFR bid - E(80)64	663
3.	Following bilateral	663
4.	EFL bid	765 (1025 outturn)
5.	Amended bid before cuts in line 6	663 (888 outturn)
6.	Reduction equivalent to 10% of the industry's investment figure	33

Assumptions underlying EFL bid (line 4)

Inflation	:	1981 on 1980	14.3%
		1982 on 1981	10.0%
Earnings	:	1981 on 1980	12.5%
		1981 settlement	10.7%
Prices increase	:	17% in November 1981	

Ministers agreed in September to allow special additional borrowing of up to £50 million (of which £40 million would be for BRB) to be applied only to meeting the transitional costs arising from BR's decision to close its loss-making parcels business. At the time Ministers also agreed that the Board should find the requirements for the remainder of their business within the total for external finance in Cmnd 7841. This would have required the Board to offset an excess requirement of £59 million which was then foreseen by means of service economies, sales of assets and a lower pay settlement than assumed at that stage. The Board's latest results, and their current assessment of the 1981 budget, indicate a severe deterioration in passenger and freight traffic. Their latest forecasts show a requirement for external finance of £765 million despite service and cost reductions yielding some £50 million. The Minister of Transport is considering urgently how far these additional demands can

/be

be met from further economies and disposals and will be reporting his conclusions.

2. A reduction of £33 million could entail changes in the present scale of operations. The proposed EFL already represents a considerable reduction from the Board's estimated requirements. They are now making significant current economies (including closure of their loss-making parcels business involving 6,000 redundancies) and further economies may be necessary to deal with even lower levels of demand than the Board are now forecasting. Sales of assets are projected to double in 1981-82. A favourable pay settlement is already assumed by the figures. Further reductions in investment, which is already at a level strongly criticised as inadequate, would be inevitable to meet the reduction.

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BRITISH TRANSPORT DOCKS BOARD

£m 1980 Survey prices

External Finance

1.	Cmnd 7841 revalued	- 9.7
2.	IFR bid - E(80)64	- 6.6
3.	Following bilateral	- 6.6
4.	EFL bid	- 3.7 (-5 outturn)
5.	Amended bid before cuts in line 6	- 6.6 (-8.8 outturn)
6.	Reduction equivalent to 10% of the industry's investment figure	1.6

Assumptions underlying EFL bid (line 4)

Inflation	:	1981-82 on 1980-81	12%
Earnings	:	1981-82 on 1980-81	10%
		1981-82 settlement	10%

The Board are net repayers of debt. A reduced level of debt repayment was entered in the IFR (although higher than that sought by the Board) reflecting worsening trading conditions. The Board's latest forecasts project a further downturn in trade and debt repayments of only £3.7 million. This assumes stringent measures are taken to offset the effect of worsening business prospects, including a reduction in investment to 40 per cent of previously planned levels. The EFL proposed is in line with the figures entered in the IFR and will therefore require further savings to be found by the Board.

2. A reduction of £1.6 million would fall predominantly on investment. The Board is an efficient undertaking operating in a competitive market. The scope for further operating economies, price increases or further downward pressure on pay is correspondingly limited. A reduction in investment to below the already severely constrained level could affect profitability, and the chances of a successful sale of shares in the Board in the near future.

BRITISH WATERWAYS BOARD CONFIDENTIAL

£m 1980 Survey Prices

External Finance

1.	Cmnd 7841 revalued	22.9
2.	IFR bid - E(80)64	22.9
3.	Following bilateral	22.9
4.	EFL bid	25.7 (34.5 outturn)
5.	Amended bid before buts in line 6	22.9 (30.7 outturn)
6.	Reduction equivalent to 10% of the industry's investment figure	-

Assumptions underlying EFL bid (line 4)

Inflation	:	1981-82 on 1980-81	15%
Earnings	:	1981-82 on 1980-81	12%
		1981-82 settlement	10%
Price increases:		20%	

The Board's major source of external finance is Government grant which is designed to meet the Board's deficit on revenue account. The proposed EFL is based upon the volume figures which were agreed by Ministers in the IFR.

2. Subject to the decisions which will be made about programme 8 in the course of the 1980 PES, in which context the Secretary of State has made an additional bid of £1m for grant to the BWB, the suggested EFL is £30.7 million. The Department consider that the EFL should be set at a level higher than this in order to accommodate additional borrowing of £1.5 million but the Treasury do not accept that such an increase would be justified.

3. A cut in external finance equivalent to 10% of investment would be de minimis.

£m 1980 Survey Prices

External finance

1.	Cmnd 7841 revalued	6.1
2.	IFR bid - E(80)64	16.1
3.	Following bilateral	11.1
4.	EFL bid	14.5 (19.4 outturn)
5.	Amended bid before cuts in line 6	11.1 (14.9 outturn)
6.	Reduction equivalent to 10% of the industry's investment figure	3.8

Assumptions underlying EFL bid (line 4)

GDP	:	1981-82 on 1980-81	+ 1%
Inflation	:	1981-82 on 1980-81	13%
Earnings	:	1981-82 on 1980-81	9%
		1981-82 settlement	9%

Of the £50 million extra borrowing which Ministers agreed could be made available to finance costs arising from BR's withdrawal from their parcels business, £10 million is being allocated to NFC to be made available only if the closure of the parcels business results in a major industrial dispute in NFC. Apart from this exceptional addition, the external financing requirements entered in the IFR reflected the Cmnd 7841 figures despite worsening trading conditions. This entailed a reduction in investment in excess of 10 per cent together with current economies. During bilateral discussions a reduction in external finance of £5 million was agreed to take account of the reduced interest burden on NFC Limited following incorporation, partly offset by a further worsening in business prospects. Further reductions were not made to avoid prejudicing the possibility of a sale of shares in 1981. The suggested EFL reflects the position reached in bilateral discussions.

2. A further reduction of £3.8 million would lead to a greater rationalisation of business operations and a consequent fall in investment. Prospects for a successful sale in 1981 would diminish further.

£m 1980 Survey prices

External finance

1.	Cmnd 7841 revalued	56.4
2.	IFR bid - E(80)64	56.4
3.	Following bilateral	56.4
4.	EFL bid	59.4 (79.6 outturn)
5.	Amended bid before cuts in line 6	56.4 (75.6 outturn)
6.	Reduction equivalent to 10% of the industry's investment figure	6.4

Assumptions underlying EFL bid (line 4)

Inflation	:	1981-82 on 1980-81	14.5%
Earnings	:	1981-82 on 1980-81	- 3.5%
	:	1981-82 settlement	5%
Price increases	:	12-15% split between January and July 1981	

NBC's trading position has worsened seriously since figures were entered in the IFR as the recession rapidly reduces traffic volume. During bilateral discussions it was agreed to make no reduction in the provision for external finance on the basis that NBC would take measures to offset an excess requirement then foreseen of £7.5 million. These projections assumed a 33 per cent reduction in investment, service reductions involving 2,500 redundancies and a pay settlement limited to 5 per cent. The suggested EFL reflects the position reached in bilateral discussion although NBC remain uncertain about whether it will be possible to meet the short term costs of the redundancies envisaged within the EFL. The Minister of Transport has warned that he may wish to propose a revision to the EFL in the course of the year to make special provision for redundancy costs.

2. A reduction equivalent to 10 per cent of investment (£4 million) would lead to further service reductions and some further reduction in investment. Prices are constrained by the market, particularly now that the provisions of the Transport Bill 1980 are in operation. The precise extent to which reductions were reflected in cuts in services rather than investment would depend on the redundancy costs associated with service reductions.

£m 1980 Survey prices

External finance

1.	Cmnd 7841 revalued	6.2
2.	IFR bid - E(80)64	11.3
3.	Following bilateral	11.3
4.	EFL bid	13.1 (17.6 outturn)
5.	Amended bid before cuts in line 6	13.1 (17.6 outturn)
6.	Reduction equivalent to 10% of the industry's investment figure	1.1

Assumptions underlying EFL bid (line 4)

Inflation	:	1981-82 on 1980-81	17½%
Earnings	:	1981-82 on 1980-81	10%
		1981-82 settlement	10%
Price increases	:	17½% (but bus fares will be increased to the level needed to generate the profit which is implied by a financial target)	

The increase in external finance in the IFR as compared with Cmnd 7841 was largely due to a forecast increase in local authority support for bus services. The figure for external finance in the IFR assumed that a medium-term target for the bus group would be set along the lines which were similar to the target for 1980 (to make a profit of £7.5 million after interest). Further calculations by the Department suggest that in order to earn the RRR in 1984, the bus group will need to make a somewhat lower profit (£4.2 million at 1980 Survey prices before interest). A medium-term target for the bus group will be the subject of a separate proposal, but the suggested EFL before further policy decisions assumes that it will be agreed that the medium-term target will require the bus group to make a pre-interest profit of £5.4 million (£4.0 million at 1980 Survey prices) in 1981-82.

2. The Department recommend the EFL which is shown in line 5.

3. A cut in external finance equivalent to 10% of investment (£1.1m) would be more likely to result in service reductions, a lower quality of service and in price increases rather than in investment cuts, as investment in fixed assets in 1981-82 will be lower in real terms than the level in the current year.

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BRITISH SHIPBUILDERS

External Finance	£m 1980 Survey Prices 1981-82
1. Cmnd 7841 revalued (for comparison)	81
2. IFR bid (provisional)	121
3. Following bilaterals*	119*
4. EFL bid	114 (153 outturn)
5. Treasury recommendation	114 (153 outturn)
6. A cut equivalent to 10% of the industry's investment figure	2 (3 outturn)

(* net of 8% squeeze on capital investment agreed at bilateral on 25 September)

Assumptions underlying EFL bid (line 4)

Inflation: 1981-82 on 1980-81: 12%

Wage inflation: Industry 9% (Settlement)

Exchange Rate: £ = Yen 500/520 [No change]

1. BS had a new Chairman in July. He has already taken steps to redu administrative costs and reduce facilities, but a substantial increase in the EFL for 1981-82 is unavoidable. World competition remains fierce, and the market prospects for merchant ships, oil-related work and naval ships are all uncertain.

2. Against this background the Department of Industry are making proposals on BS finances and strategy in a separate paper to E Committee. As a price taker BS is unable to assume that internation prices will move in its favour. The new Chairman is assuming a pay increase of 9 per cent from 1 April 1981 and an increase in material costs of 12 per cent during the next financial year.

3. The cash figure of £153 million for the EFL assumes that a start will be made on closing Smiths Dock and Vosper Shiprepairs in 1981-82. Further closures/rundowns would add to the pressure on the EFL, but

lack of orders could mean that more job losses are unavoidable at other yards. The Treasury agree with the Department that an EFL of £153 million is the best judgement which can be made at this stage.

4. If investment in fixed assets were to be reduced by a further 10 per cent in addition to the already agreed 8 per cent, the reduction in the EFL would be about £2 million at 1980 SP. A substantial part of BS' capital investment for 1981-82 is required for the Trident programme.