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Treasury Chambers, Parliament Street, SW1P 3AG

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Private Secretary to
Secretary of State
Department of Energy
Thames House South
Millbank
London
SW1

5 June 1985

Dear Geoff

NATIONALISED INDUSTRIES LEGISLATION

The Chief Secretary met NICG representatives on 17 May following the agreement at E(NI)(85) 1st meeting that he should complete consultations with the Chairmen.

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It is possible that individual Chairmen may refer to these discussions in talking to their sponsor Ministers. The Chief Secretary has asked me therefore to circulate, for information, the note of the discussion together with a copy of a subsequent Memorandum from the NICG. The latter sets out the Chairmen's formal observations on the joint note of 29 March by Treasury and NICG officials, which recorded the common ground reached on the objectives of the proposed legislation.

The Chief Secretary is considering the points raised in those further discussions with the NICG. He will be reporting his conclusions to E(NI), as requested at the meeting on 25 April, in due course.

I am copying this letter and attachments to the Private Secretaries of members of E(NI) and to Sir Robert Armstrong.

Yours ever
Richard Broadbent

R J BROADBENT
Private Secretary

NOTE OF A MEETING HELD IN THE CHIEF SECRETARY'S ROOM ON 17 MAY 1985

Present:

Chief Secretary	Sir R Haslam)	
Mr Bailey	Mr J Dent)	Nationalised
Mr Monck	Sir R Dearing)	Industries'
Mr Moore	Mr P Jones)	Chairmens'
Mr Grimstone	Mr D Miller)	Group
Mr Hyman	Mr J Driscoll)	
Mr Palmer	Mr J Baxter)	

The meeting followed the Chief Secretary's letter of 7 May to Sir Robert Haslam (annex).

2. Welcoming the Chairmen, the Chief Secretary explained that Ministers had decided to give priority in the 1985-86 Parliamentary Session to legislation to privatise gas. Consequently that Session would not include any general nationalised industry legislation. However, he believed that the discussions which had taken place with the NICG had been very useful. He would find it helpful to know how the full NICG Council had reacted to the note agreed between Treasury and NICG officials following the 25 March meeting. He would be reporting to Ministerial colleagues before deciding how to take matters forward.

3. Sir R Haslam reported the Chairmen's reaction that the agreed note represented a major advance. There were two general points which the NICG nevertheless wished to reiterate. First, their belief that the Government - nationalised industry relationship should mirror, as far as possible, that between a private sector company and its major institutional shareholders. Second, that nationalised industry accounting practice should not get out of step with the private sector. Sir R Haslam then proceeded to outline seven points arising from the agreed note which the Chairmen wished to record.

Capital Structure; Rate of Return and Dividend Policy; EFLs

4. The Chairmen had the following observations:

- (a) they believed that capital structures would necessarily have to vary considerably between industries. Gearing should broadly mirror what was found in a large private sector company in a similar line of business. They did not, however, believe that a distinction between preference and ordinary shares would be useful in the nationalised industry context where the Government held all the equity;
- (b) they considered that, in the type of regime outlined in the agreed note, the industries would want to pursue a progressive dividend policy comparable to private sector companies. Profit distribution would need to be tailored to the nature of the individual business. A lower proportion might, for example, be distributed if an industry was undertaking a major investment programme. The ability of an industry to pay a dividend would, however, be the measure of the business's success. The maintenance of a progressive dividend policy would also make industries and their employees more cash conscious, emphasising the level of profits which would need to be earned. Other targets were likely to detract from this. They did not believe that the Government would lose anything by relying on dividend policy alone rather than setting also a financial target;
- (c) they also believed that the introduction of dividend targets should not be accompanied by continuation of negative EFLs. If the Government wished to extract additional payments from the industries, this ought to require separate Parliamentary approval, perhaps via inclusion in a Finance Act (by analogy with the Gas Levy). More generally, the Chairmen questioned the desirability of retaining EFLs in the new operating environment envisaged. It would be psychologically important to recognise the changes which would result: at the very least EFL terminology would need to be

altered. Although it was accepted that there would have to be continuing controls over industries' borrowing, Mr Miller stressed the desirability, as in the private sector, for an industry to have a reasonable degree of assurance that it would be able to undertake the necessary borrowing for the duration of lengthy, major investment projects.

- (d) in considering rates of return, the Chairmen considered that any assessment of asset values should reflect the view of an industry's Board and its professional advisers as to the worth of those assets to the business at the time. In this, private sector practices should be followed. There was concern in the NICG that the work currently being undertaken in the Treasury-chaired Technical Group considering asset valuation principles should not act across this general principle.

5. In discussion, the Chief Secretary acknowledged the Chairmen's wish closely to follow private sector practice but noted that the analogy could not be pushed too far in view of the points made in officials' note. He confirmed that if dividends were paid to the Government then the same cash could not be extracted again from the industries through negative EFLs. However, EFLs had a wider relevance as a measure of public expenditure, for example in the annual Public Expenditure White Paper, and even if the terminology were altered the Government would still be concerned with the figures. Treasury officials questioned the circular effects of basing valuation of assets on their worth to the business if the worth was effectively determined by a target return on capital set below the rate of return in the economy generally. They also doubted whether the existence of both financial and dividend targets posed a problem. The starting point, as now, might be the financial target with a dividend policy consistent with this then being agreed.

6. Sir R Dearing suggested that one way of further exploring the detailed way in which capital restructuring might work

would be to investigate the possibilities in relation to one industry. He offered the Post Office for such a study. The Chief Secretary thanked Sir R Dearing for the offer and agreed to consider it further.

Resolution of Government-Industry Disagreements

7. Sir R Haslam indicated the NICG view that where major disagreements over core issues arose between the Government and a Board leading to Ministerial directions, these should be properly debated in both Houses through an affirmative rather than negative resolution procedure. The Chairman accepted that for financial matters, constitutional propriety would restrict this to the Commons.

Privatisation

8. The Chairmen believed this subject merited fuller treatment than in officials' note. In particular, they held to their earlier view that primary legislation should be required for any privatisation involving an important part of an industry's core business (BSC's tinplate activities were suggested as an example.) For peripheral business areas, secondary legislation ought to be sufficient but via affirmative rather than negative resolution procedure.

Terms of Appointment of Board Members

9. Sir R Haslam reported the Chairmen's view that Ministerial powers of dismissal should be restricted to the Chairman alone. If a Chairman was removed in circumstances in which he had his Board's support, the non Executives could be expected to resign. However, he agreed that a provision would be desirable which allowed removal of a member with appropriate compensation in cases where a Chairman and the Secretary of State agreed that this was appropriate. The NICG paper commenting on the Government's proposals was currently being revised to take account of earlier discussions. It was due to be considered

by the relevant NICG sub-group on 13 June and by the NICG Council on 12 July. He would, however, try to obtain an agreed position at the former meeting, having first taken the view of other NICG members, to expedite a response to the Chief Secretary. The paper would be comprehensive including, for example, a view of the sort of tenure which both Executive and non-Executive Members would expect.

Conclusion

10. The Chief Secretary thanked the Chairmen for giving him their views; he appreciated the careful study which this had involved. He believed that it would now be useful if an addendum could be agreed to the previous joint Treasury/NICG officials' note covering the points raised in the present discussion. He suggested officials might liaise on this. He would be reporting back to his colleagues in due course.

C A PALMER

22 May 1985

Circulation

Those present (HMT)
PPS
Financial Secretary
Minister of State
Economic Secretary
Sir Peter Middleton
Mr Byatt
Mr Cropper
Mr Lord
Mr H Davies

NATIONALISED INDUSTRIES' CHAIRMEN'S GROUP

OBSERVATIONS ON THE JOINT MEMORANDUM

GENERAL ATTITUDE

1. The arrangements outlined in the Joint Memorandum are clearly better than those outlined in the Consultation Note of 20.12.84. Even so, when the NICG Council met on 25th April, it identified a number of points on which it wished to see further improvements made; and it reserved the right to withhold a positive commitment until the Government's views on those points had been elucidated and the final framework could be seen.
2. In approaching this whole issue, the basic criterion which the Chairmen's Group has had in mind is that the relationship between the Government and the nationalised industries should mirror the private sector pattern as much as possible, since experience suggests that this is likely to be the best way to ensure the effectiveness of the nationalised industries as business enterprises. Admittedly, the "private analogy" cannot wholly apply; but in the broad, the intention should be to bring the relationship between the Board of a public sector Corporation and its sponsor Minister into line with that normally prevailing between the Board of a large private sector company and a financial institution which holds the predominant part of its shares.
3. If that basic criterion is to be satisfied, the accounting practices to be followed by the Corporations will need to be the same as those applied by major private sector companies. This principle of equivalence should take precedence over any preference for some particular accounting approach.

PARTICULAR RESERVATIONS

4. Negative EFLs, [Joint Memorandum, para.13]. Once the concept of dividend payments has been introduced, it will be illogical for negative EFLs to continue to be set. If the Government sees good reason to impose some additional impost on a Corporation, over and above its dividend payments and normal tax liabilities, then it should seek separate legislative approval for such a special charge, as was done for the Gas Levy through the Finance Acts.
5. Positive EFLs, [JM, paras. 13-14]. The Chairmen's Group accepts that Ministers will need to maintain some form of control over the scale of borrowings by those Corporations which have to call on external sources of finance. Even so, it would help to signify the overall change in relationships which is envisaged if the existing system for doing this, ie. the announcement of positive EFLs, were to be dropped and some new terminology introduced.
6. "Parliamentary Adjudications", [JM, para.17]. The Chairmen's Group welcomes the fact that the Joint Memorandum moves away from the earlier proposal to give Ministers the right to impose statutory targets, and instead envisages normally proceeding by way of agreement between Ministers and the Boards. It accepts that, if major disagreements were nevertheless to arise over balance sheet restructuring, the overall profit to be sought or dividend policy, and these could not be resolved in any other way, Ministers

should have the right to bring proposals to Parliament for adjudication. However, in this event, Ministers should be required to proceed by introducing Affirmative Resolutions in both Houses of Parliament, (except where constitutional practice indicates submission to the Commons alone).

7. Balance Sheet Restructuring, etc., [JM, paras. 7-9]. Five points arise :-

- (a) The concept of a three-part capital structure is welcome; but it should be acknowledged from the start that the balance to be struck between the three elements will necessarily need to vary from Corporation to Corporation.
- (b) With regard to the debt element in that revised capital structure, the Chairmen's Group, which was gravely concerned about the earlier suggestion that Ministers should be able to impose decisions involving the conversion of reserves into debt, welcomes the fact that the Joint Memorandum embodies two safeguarding provisions in this connection :-
 - that with regard to balance sheet restructuring generally, the power to initiate proposals should lie with the Board concerned; and
 - that with regard to the creation of debt from reserves, any such step should require the specific agreement of the Board concerned, and should be done only in order to provide a suitable gearing.

In connection with that last point, the Chairmen's Group remains altogether-unconvinced that it would be equitable to convert reserves which have been built up on the basis of the achievements of the Corporations concerned and the contributions of their customers into fixed-interest debt to be owned by the Treasury. At very least, the gearing in any reconstructed balance sheet should be similar to that which would normally be expected to occur in a large private sector company in a not-dissimilar industry.

- (c) Any assessment of what is meant by the "up-to-date value of the assets employed" when a balance sheet is reconstructed should reflect the judgement of the Board and its professional advisers about the continuing worth of the business, using the same methods of appraisal as would normally be applied by private sector Boards in similar circumstances. The Chairmen's Group would be strongly opposed to any suggestion that this process should be replaced by the application to the nationalised industries alone of special rules based on a CCA calculation of asset values.
- (d) The role suggested for preference shares has no validity, since with the Treasury holding all the equity, such shares would simply give the Government preferential claims over itself.

8. "Double Targetry", [JM, paras. 10-14]. The Chairmen's Group is concerned about the complications inherent in the proposal to set rate of return targets as well as dividend targets. There is no intention to suggest that matters other than dividend targets should not be discussed. On the contrary, both the level of profit (or loss-reduction) to be aimed at, and policy towards the various factors which bear on how much of that total profit will be available for distribution as dividends, will necessarily

be major matters for consideration and agreement between each Corporation and its sponsor Department in the context of the annual discussions on the Corporate Plans. Nevertheless, in terms of formal targetry, priority should attach to reaching an agreement on a progressive dividend policy for each Board. This particular target subsumes all the other prior steps in the Board's corporate planning; it provides the public-at-large with a readily-understandable test of the Corporation's effectiveness; and it accords with the "private sector analogy" which should shape all aspects of the new arrangements.

9. Dismissal of Board Members, [JM, para.18]. NICG believes that the proposed power to dismiss Board Members, with which it is suggested that Ministers should be equipped as their "ultimate discipline" over the Boards, need apply to Chairmen only. If a Chairman were to be dismissed following a basic disagreement with his sponsor Secretary of State, his Deputy Chairman and the non-Executive Members of his Board, having hitherto supported him, would doubtless feel obliged to consider very seriously indeed their own positions regarding continuing membership of the Board; and this should be taken as sufficient to satisfy the purpose in mind: while the extension of the Minister's ultimate disciplinary power to cover career Executive Members would be neither necessary nor desirable. The position regarding the dismissal of Executive Members on the ground of ineffectiveness will be dealt with in the detailed paper on the Board Appointments issue as a whole which NICG plans to submit in the near future.

10. Privatisation, etc., [JM, para.5]. The Chairmen's Group has indicated its readiness to discuss possible legislative changes bearing on company formation and Privatisation on the basis of the proposals set out in the Consultation Note of 22.12.84; but this should not be taken to imply that it is broadly satisfied with the content of those proposals. It has already raised two major points in this connection, in the memorandum tabled on 27th February, [Annexe, para.A10] :-
 - that primary legislation should be required, not only in the event of a move to privatise the whole of a Corporation, but also in the event of a move to privatise any significant part of its main-line activities; and
 - that in the event of a move to privatise any appreciable peripheral activity, recourse to the "affirmative Order" procedure should be required.

In addition, individual Corporations raised a considerable number of points about this part of the Consultation Note, bearing on the situation of subsidiary companies, etc., during their consultations with their sponsor Departments during February and March.

NATIONALISED INDUSTRIES LEGISLATION

Note by HM Treasury and NICG Officials

Following on from the meeting held between the Chief Secretary and the NICG on 25 March, this note records the common ground that has been reached between NICG and Treasury officials on the underlying objectives which should shape the proposed nationalised industry legislation and on the broad outline of the proposals which follow. Subject to its agreement by Ministers collectively and by the NICG, it is intended to serve as a basis for further discussion of the details of the proposed legislation.

General Objectives

2. The central objective of the proposed legislation is to increase the effectiveness and commercial vitality of nationalised industries. It is intended to strengthen the industries to the point where they can either be transferred to the private sector or remain as successful businesses within the public sector where this is appropriate.

3. The overall effect of the proposed legislation will be to move the industries closer to the position of large private sector companies at a pace to be decided in light of the situation of individual industries. As long as industries remain in the public sector, the analogy with private sector arrangements cannot be exact and it will be necessary to ensure that the legislation makes provision for the needs of public accountability and the special circumstances of nationalised industries. These include the degree of monopoly power possessed by some industries, the fact that the Government is perceived as standing behind the industries financially and that some industries are at present not profitable, the need to protect consumers, and the need to ensure that resources within the public sector generally earn an adequate rate of return in comparison with that earned in the private sector. Subject to this however, the powers would provide for disciplines corresponding to those found in the private sector

to be maintained. Wherever it is appropriate, Ministers' powers will be comparable to those of controlling shareholders in large private sector companies.

4. It is agreed that the proposals should seek to introduce a greater degree of uniformity into industries' individual statutes where this can be done without cutting across the very wide differences in their industrial and commercial situation.

5. The NICG accepts that the provisions in the consultative document other than those set out below can serve as a basis for discussion but will wish to review further the details of what is proposed. This acceptance covers borrowing and guarantees; accounts (except accounting principles), reports and audit; and restructuring and privatisation. Discussion of terms of appointments of board members awaits a further note that is being produced by the NICG (although see paragraph 18 below).

6. It is common ground that in implementing the provisions of the proposed legislation, Ministers would generally hope to proceed by agreement with the boards of the industries concerned.

Capital structure

7. It is intended to take enabling powers that would allow the capital structures of nationalised industries to be moved closer to those found in large private sector companies, implying an appropriate mix of state-owned public equity capital^(PEC) loan capital, and reserves. This would strengthen financial disciplines and reduce the need for ad hoc intervention. The legislation should equip Ministers with whatever powers are necessary to give effect to this intention.

8. In carrying out any such restructuring, proper account would be taken of professional advice as to the up-to-date value of the assets employed. The construction of proposals would be the responsibility of the appropriate board although Ministers would be able to initiate the process by asking a board to submit a recommendation. All restructuring proposals would be discussed on a case by case basis between an industry, the Secretary of State,

and the Treasury.

9. The equity element of the new structure could take a number of forms, having the characteristics of cumulative preference as well as ordinary shares, in proportions appropriate to the circumstances of an industry (with profitable industries normally having a greater proportion of preference capital). Additional debt would be created from reserves only with the specific agreement of the appropriate board and in order to provide a suitable gearing. In order to add flexibility between major restructurings, a board would be able to propose at the end of any accounting period, that reserves be converted into additional PEC in a way that would parallel scrip issues in the private sector.

Rate of return on capital and dividend policy

10. Listed companies in the private sector are subject to a variety of financial disciplines which stimulate them to seek to earn an adequate return on capital. If their return on capital employed falls below that generally applying in the sector in which they operate, they are at risk of takeover; and in a less drastic sense their financial performance is closely monitored by investment analysts and, if performance is below par, the company's share price will suffer. These disciplines do not exist in the public sector but somehow have to be replicated. It is agreed that this should be done by boards and Ministers agreeing from time to time an appropriate target rate of return on capital employed in an industry. Existing arrangements for setting cost-reduction targets would continue unchanged in light of the particular circumstance of the business.

11. At the same time, the dividend targets' would be agreed that should apply over the target period. The actual level of overall dividends to be paid in any one year on an industry's share capital (ordinary and preference) would be proposed by the board in a way analogous to company practice and would reflect trading performance and profitability. Preference dividends, if not paid fully in any one year, would be expected to cumulate over the target period.

12. Achievement of rate of return targets and dividend targets would not be expressed in terms of a duty upon a board but as a best

endeavours aim enshrined in statute. Boards would be required to conduct their business with a view to achieving whatever rate of return and dividend targets had been agreed

13. Appropriate rates of return and dividend targets would be discussed as part of a corporate plan dialogue. This might review such factors as industries' expected future finances and investment intentions, the levels of proposed calls on external finance, and the balance between dividend distribution and allocations to reserves. The general intention would be to agree rate of return targets and dividend targets that would cover a target period of at least 3 years. NICG note the Government's intention that present arrangements for setting EFLs would be unchanged, although the incidence of negative EFLs should be greatly reduced.

14. Additional controls would generally be appropriate for loss-making industries and their financial targets might take the form of loss reduction targets. Dividends would be inappropriate until financial health was restored.

Accounting principles

15. The accounting principles to be laid down by the Secretary of State will be intended to result in true and fair accounts and follow generally accepted accounting practice except where peculiarities in the industries' situation clearly require special provisions.

Discipline

16. Ministers would generally hope to proceed by agreement with the boards of the industries concerned. It is not the Government's intention to undermine the position or the authority of the industries' boards.

17. There are however cases where public accountability requires

tain rights to be reserved to Ministers (eg approval of borrowing). Additionally, in certain key areas, if Ministers felt that the national interest was not being sufficiently recognised, the authority for resolving disagreement would be Parliament. This implies that if agreement cannot be reached on balance sheet restructuring, the target return on capital, or dividend policy, specific Parliamentary approval would need to be sought if exceptionally Ministers wished to proceed other than by agreement.

18. As part of a set of new measures which would move the industries closer to the position of large private sector companies, the NICG accepts that the major ultimate discipline available to Ministers should be the power to dismiss board members though the position of executive members will need further consideration. Further discussion of how this would operate in practice awaits finalisation of a note that NICG are preparing.

29 March 1985