NEW THINKING ON THE NATIONALISED INDUSTRIES

Value for Money Audits

John Hatch and John Redwood

Centre for Policy Studies

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"The government will keep under review the possibility of strengthening arrangements for the external monitoring of these industries which enjoy substantial protection from competition."

"It (the government) hopes that they (the nationalised industries) will develop further the role of these Audit Committees, or set up comparable arrangements, to look more generally at questions of efficiency and performance within their industry."

The Nationalised Industries
Cmnd. 7131 March 1978

VALUE FOR MONEY AUDITS

	CONTENTS	PAGE
CHAPTER 1	The Scope of the Problem	1
CHAPTER 2	The Present System of Control	7
CHAPTER 3	The Case for a VFM Audit	13
CHAPTER 4	The Operation of a VFM Audit	19
CONCLUSIONS		23

CHAPTER 1

THE SCOPE OF THE PROBLEM

In March 1978 the government White Paper on the nationalised industries outlined their significance to the economy in the following terms:–

> "The nationalised industries are major users of national resources. They employ about 1,700,000 people, or 7% of the country's total labour force. Their total investment this year and next is about £3,500 million at 1977 prices, and in 1976 they accounted for 14% of total fixed investment. A considerable part of their capital requirements is financed by advances from, or guaranteed by, the Government, and in 1976-77 these represented about 15% of the total Public Sector Borrowing Requirement of £8,800 million. In 1976 they contributed about 10% of the total output of the U.K. economy. They dominate four strategic sectors of economic activity: energy, public transport, communications, and iron and steel. They supply basic goods and services to industry, and essentials of life to individual consumers. They are themselves major customers of some of the capital goods industries, and the scale of their purchases means that some of these supplying industries are heavily dependent on their strategic decisions and investment. In short the nationalised industries have a pervasive influence throughout the economy on investment, employment, industrial costs, and on the cost of living. The share of national resources going to them, and the efficiency with which they use these resources, are matter of major importance".

Since 1978, the nationalised industries have become more important still. In 1979-80 they absorbed £3,000 million of government grant, Public dividend capital, and net borrowing from

the National Loans fund, to help finance capital spending. In the forseeable future it seems likely that the industries' cash requirements will exceed this figure and in 1981-82 could account for half the public sector borrowing requirement (PSBR).

At the same time there has been a chorus of complaint about the way the industries are being run. In three of the four sectors (energy, transport and communications) customers have complained bitterly about price increases which, overall, have greatly exceeded the rate of inflation attributable to the private sector. The rise in oil prices does not wholly explain this difference. In the fourth sector (steel, and engineering) competitors are complaining about the dangers of subsidised prices being too low.

The trades unions, in a number of industries, are becoming understandably restless in the face of proposed cut-backs and restricted growth plans. In many areas this concern is shared by local authorities who will be faced with the social and economic after-effects of rising unemployment. Even the managements of the industries are dismayed at the way in which their capital investment programmes are being cut to reduce the public sector borrowing requirement.

The government is not unaware of these problems; nor, for the most part, is it to blame for their existence. In many cases the roots of the problem go back years, if not decades. Moreover, by May 1979 some of the problems had been allowed to escalate unnecessarily within the previous few years. Nevertheless the present government must live with its inheritance. Without a marked improvement in the affairs of the nationalised industries it seems unlikely that the government's overall economic strategy can succeed.

Several remedies have been proposed. The most satisfactory is some form of privatisation. In certain respects progress in this direction has been slower than expected and, at the conceptual level, the government has been reticent in explaining and identifying the three different strands of the policy. First, there is the introduction of private capital. This may either fund or reduce the PSBR. To a lesser or greater extent it may therefore help maintain the capital investment programmes of the nationalised industries, and it should help to moderate the more blatant mis-uses of funds for electioneering purposes.

Second, there is the transfer of control from a government department to private sector shareholders. This enables investment, and other, decisions to be taken on a normal commercial basis. Third, there is the removal of monopoly privileges to introduce or increase competition. These three strands are obviously inter-related. The introduction of competition implies that firms

controlled by private sector shareholders will enter the industry. Similarly if firms are controlled by private sector shareholders one hopes that they will put up the money.

With these distinctions in mind the present progress is as follows:

Energy

Oil	Private capital may be introduced by equity sales in due course. Oil bonds will be sold to the public.
Electricity	Minister has stated intention to permit competition in electricity generation.
Gas	Private control of a new gas gathering pipe-line has been discussed including BGC participation.
Coal	None.

Public Transport

Freight	Private control of National Freight Corporation has been proposed by the Minister and powers taken in the Transport Act 1980.
Buses	Increased competition permitted under the Transport Act 1980.
Rail	Private capital will be introduced into non-rail activities of British Rail: companies have been set up under a holding company umbrella to facilitate this.
Docks	Minister has suggested sale of 49% of British Transport Docks Board.
Airways (under Trade Dept)	Private capital will be introduced into British Airways; powers have been taken under the Civil Aviation Act 1980 but the share sale has been delayed.

Communications

Telecommunications	Limited competition permitted under British Telecommunications Bill. Private capital may be introduced through bonds.
Postal Services	Possibility of competition if the Secretary of State suspends the monopoly under The Post Office Bill.
Cable & Wireless	Stated intention to sell this company in the autumn; powers being taken under Post Office Bill.

Steel, and Engineering

Steel	Danger of reduced competition.
Aircraft	Shares sold in British Aerospace so that the government is left with a minority holding.
Ships	Introduction of private capital into British Shipbuilders deferred.
Cars	None (BL)
Aero Engines	None (Rolls-Royce)

Local Authority Direct Labour Departments

New rules for tendering under local Government Planning & Land Act 1980 to foster competition.

In addition the National Enterprise Board has been required to sell some shareholdings, including ICL and Ferranti; and local authority direct labour organisations are being required to compete with the private sector.

For those who believe that effective competition benefits consumers this list is a little disappointing, although it would be churlish to minimise the practical difficulties involved. In particular, of course, the real benefits of greater competition will only arise if U.K. private sector firms are ready to respond vigorously to the new challenges which may be set. Nevertheless two facts remain. Whatever happens during the remaining life of this parliament, the bulk of the nationalised industries are likely to be with us in much their present form; and the industries which currently give rise to the biggest problems are likely to be the most difficult to privatise. In short, privitisation is not going to solve the problems of the nationalised industries within the time-scale that is required.

Another possible remedy, which is currently attracting interest, is to re-examine the definition of PSBR to see whether genuinely productive investment, which would be perfectly acceptable to the private sector, could not be separated out in some way. This might, for example, make it easier to sanction investment in telecommunications without a disproportionate increase in prices to present customers. The practical advantages of such a move are so obvious that it seems permissible to strike a note of caution for the longer term. Any general scheme for classifying investment as 'productive' is likely to involve formal investment appraisal techniques using discounted cash flows and a test rate of discount. This raises two possible difficulties.

First, it is by no means improbable that meticulous calculations will be carried out on the basis of revenue and cost forecasts which are grossly inaccurate. If expensive mistakes are made, as they have been in the past, the private sector's initial enthusiasm for a project may not make it liable for paying all the resultant bills. In other words, merely designating a project as productive does not ensure that it actually will be.

Second, in order to use a test rate of discount it is necessary to specify its amount. Whatever casuistry may be employed in its defence this is bound to be an arbitrary figure, and in practice it is likely to be pitched on the high side. As a result it may rule out a few marginal investment projects and these may or may not, include some that would have gone horribly wrong. As a further result, however, it may also bias the decision as to the choice of technique in the cases of many intra-marginal and highly desirable investment projects. In general the bias will be towards labour or fuel intensive techniques and away from those requiring heavy initial capital expenditure.

Another suggested remedy is to give more effective power, and information, to organised consumer representatives within appropriate industries. In principle this is a good thing but it is important to be clear about the limitations and the opportunities inherent in this role.

In a fully competitive market the consumer is sovereign because his transactions perform two functions. They signal his wants and they transfer the resources necessary to pay for achieving them. If his needs are not met the resources are not forthcoming, and the owners lose their capital and the employees lose their jobs.

A consumer representative in a nationalised industry can play this first role very well. In the broadest sense he should be quite capable of identifying and promoting the interests of consumers, and on specific issues he should be a reasonable judge of what they want (and perhaps equally important what they don't want). When it comes to payment, however, he is in a quite different position particularly if the taxpayer, through the government, is expected to make a contribution. On the issue of consumer wants versus taxpayers' money he cannot (or should not) claim sovereignty, but must accept his less exalted role as yet another claimant on the public purse.

There may, however, be another way to bridge the gap between consumer wants and their own resources, as opposed to those of taxpayers in general. If the shortfall occurs because the management are incompetent or the labour force are idle, the consumer representative may wish to point this out and demand remedial action from the culprits rather than ask the tax-payer to cushion them. At the present time this very useful role is perhaps not undertaken as effectively as it might be. There are probably two reasons for this. First, consumer representatives are not really sure how to assess managerial competence and, even if they were,

they are not always provided with sufficient information. Second, they are reluctant to criticise even the most flagrantly anti-consumer trade union actions because they have been brainwashed into believing that this would be 'union-bashing'. These problems are not insuperable.

We see competition as the ultimate guarantor of consumer responsiveness and high productivity. Where competition is lacking some proxy must be found for the control and discipline which it exerts. In the next chapter we therefore look at the present system of controls of the nationalised industries.

CHAPTER 2

THE PRESENT SYSTEM OF CONTROL

We are going to look at the controls which exist for the 'traditional' nationalised industries which carry on trading activities under the supervision of boards of directors. We must not forget, however, that there are other vast tracts of economic activitiy which are undertaken within the public sector within a different institutional framework. These include defence; law enforcement; health care; education; housing; refuse disposal; fire services; public transport in large cities; and water and sewage.

For many of these activities the necessity of value-for-money auditing has already been recognised. Indeed our own views are rooted in the practical experience of developing an effective and economic system of VFM auditing for use in local authorities. This system is currently being adapted for use in the water industry, which still retains links with the local authorities but which wishes to become, and is becoming, more like a 'traditional' nationalised industry.

There is nothing particularly unusual about the boards of the nationalised industries. It is true that the chairmen are appointed directly by the minister, rather than the board, and the minister also has both effective and formal power to nominate and appoint individual members. This can make it slightly more difficult to build up a team spirit and it is not unknown for ministers to delay slightly longer than is perhaps reasonable when deciding appointments and re-appointments. These minor impediments, however, do not amount to a serious case for radical reform of the methods of appointment.

In composition, the boards, taken as a whole, reflect a reasonable balance of executive and non-executive members. Given all the circumstances, ministers have made a reasonable to good job of recruiting people to sit on the boards and they have often taken a positive and imaginative approach to the appointment of non-executive directors in particular. As one might expect, the

management styles of the boards seem to vary from industry to industry but this must partly reflect differences in the approaches of individual chairmen who tend, in general, to play a fairly dominant role in each of their respective industries.

The boards do not, at present, reflect any significant progress towards the appointment of employee or consumer representatives. We do not find this surprising because there is as yet no clear general agreement on the roles that these representatives might play. In the case of employee representatives we are not convinced that such general agreement is likely to be found, at least in the foreseeable future. As far as consumers are concerned, however, we have already sketched out the basis for a useful and constructive role and we shall touch further on the practicalities of this in due course.

For the moment, however, we take the boards as we find them. They are the people who are accountable for the performance of their industries and there is no doubt that they must remain so. Their record is patchy. There are some very considerable achievements to their credit which they may fairly claim are too often under-rated. Equally there are a number of major disasters. Broadly speaking we would put these down to four factors. First, there are the reasonable commercial gambles that failed to come off. Second, there is the absence of fear of bankruptcy under the force of competition. Irrespective of good intentions this is bound to dull the cutting edge of policies to remove inefficiency. Third, the industries are so big that it is impossible for the boards to concentrate on all the problems at once. Any deficiencies in the management information systems, which clearly exist, mean that the board is not able to take a considered view. The sheer scale of operations makes it impossible for the board to overcome organisational inertia, where it exists, in all areas simultaneously. Fourth, the boards are subject to too much political interference. They have been forced to accept planning frameworks which in some cases have owed more to wishful thinking and political expediency than hard analysis. They have been cajoled and blackmailed into accepting 'advice' from ministers on matters which are essentially operational. They have spent too much time engaged in ritualistic debates with parliamentary select committees where too often the major objective has been to circumvent the essential issues.

In theory the control execised by ministers is deceptively simple. They appoint the board members, give directions on matters of strategic national importance, and set the financial framework. In practice their role is rather more ambiguous, and it is instructive to consider three elements.

On questions of operational policy the temptations for ministers to interfere are obvious. As we indicated at the start of the first chapter the activities of the nationalised industries have a major impact on the economic well-being of very large numbers of people. It is hardly surprising if experienced politicians should fail to ignore the political implications of the way this influence is used and to try, where possible, to nudge events in their direction through informal channels. Moreover ministers are only human. Perhaps we sometimes overlook the obvious fact that in a masochistic sort of way they actually enjoy dabbling in the affairs of large and important commercial undertakings. In either case the remedy is fairly clear and has been shown to work. The chairmen and their boards must simply decline to participate in this arrangement. Alas of course this does not always occur because they themselves, by dint of accepting appointment, sometimes have a reciprocal hankering for dabbling in political affairs. They are only human too.

Ministers also face a clear and natural temptation to nag the industries into achieving greater efficiency. This is praiseworthy in principle but as a practical method of approach it has three drawbacks. If the board do not possess the really crucial management information in precisely the right form, which they sometimes do not, then it is difficult to see how the minister and his staff can obtain it when they are one stage further removed. If the problems arise through the board not having time to deal with all cases of organisational inertia simultaneously, then it is difficult to see how the minister is going to have more time. If the minister is to make his nagging plausible, albeit relatively ineffective, he needs to be briefed by intelligent people who might be employed more productively in other activities.

The matter of the financial framework for the industries is particularly instructive. Not so long ago the industries were merely enjoined to break even taking 'one year with another', which in practice meant at their own convenience. Then they were told to earn specified rates of return on their investment projects and base their prices on marginal costs. In theory these rules should have more or less pre-determined the profits they should be making but in practice, of course, they did not because the investment projects turned out differently and the calculation of marginal costs proved to be more of an art than a science. So, short-term financial targets were set; and in due course they were not always met and nothing much happened.

Finally, ministers grasped the nettle and imposed external financing limits. These, for all their crudity have had a marked, and we would maintain, predictable effect. For the first time the boards faced something akin to the threat of bankruptcy within a

competitive environment and their efforts to cut costs have suddenly acquired a new degree of urgency. On balance this will prove beneficial, but the crudeness of the approach has its drawbacks. As we have seen, in the short term an overall cash constraint can hit useful capital expenditure just as much as, if not more than, it hits wasteful revenue expenditure. If the board's problem is that it doesn't know precisely where the inefficiencies are, or doesn't have the time to push through all the remedies simultaneously, then a cash limit alone will not go to the heart of the matter. This weakness in the system provides an opportunity for special pleading to increase the cash limits, as current experience shows.

Parliamentary control rests upon the work of various select committees. Powers to investigate the various nationalised industries have recently been transferred from the old Nationalised Industries Select Committee to committees organised around the work of the sponsoring departments. These are as follows:–

Energy	British Gas, Electricity, BNOC, National Coal Board.
Industry	British Steel, Post Office, British Shipbuilders.
Transport	National Bus, British Rail, British Transport Docks, National Freight.
Trade	British Airways, British Airports.
Environment	British Waterways.

These Committees have powers to call for evidence, in writing or orally, and to report on the progress made in managing the industry. The important Treasury Committee can also investigate any financial matter arising out of the links between nationalised industries and public finance. This new structure is in some ways superior to the old one in that specialist committees can now see the work and success of their particular nationalised industries within the context of the departmental policies. Against that the Treasury Committee becomes very overloaded and matters of general economic policy often predominate. The danger is therefore that no single committee will now conduct comparative investigations into matters of common interest in the nationalised industries such as the application of common investment criteria and the operation of external financing limits.

The Select Committees have a very important role to play in scrutinising major policy issues. Once they get beyond this, as they should, to satisfying themselves that value for money is being obtained they face even greater difficulties than the minister. Their resources are more limited and the speed with which they can pursue points of detail must be tempered by the need to maintain a consensus of opinion. Perhaps more than any other of the agents of control the Select Committees have the job of evaluating the facts, rather than researching them; and adjudicating on the progress made towards greater efficiency, rather than seeking to help it along in detail.

The nationalised industries', consumer councils provide another possible method of control. In practice they have not been terribly effective and their future structure and role is currently under review. Historically they were born out of a vague sentiment that it was unreasonable to create vast statutory monopolies without providing any recognised forum for the customers to put their point of view. Once they had been established, however, successive governments made it quite clear that they did not have the slightest intention of letting the councils have any real weight on the most crucial issues. We have already stated our view on the difficulty of debating the issue of consumers versus tax-payers, and we believe this difficulty has bedevilled the government's preceptions of the councils.

On the other hand, we have also outlined our view that consumer representatives could play a constructive part in the quest for value for money. This of course would be additional to, and quite compatible with, their continuing to exert a humanising influence as the 'consciences' of the industries. Two examples will perhaps illustrate that this theme is already being developed.

First, the consumer movement is now playing a major role, in co-operation with the government and some of the industries, in the development of performance indicators. The Electricity Consumers Council; the Central Transport Consultative Committee; the National Gas Consumers Concil; and the Post Office Users National Council have all been particularly active in this field. In addition the National Consumer Council is undertaking complementary research to identify the common framework which might co-ordinate the method of approach across all the relevant industries. Performance indicators, of course, provide measures of output and as such they are an integral part of any systematic approach to value-for-money auditing.

The second example can be given by way of a quotation from Report No. 24 of the Post Office Users National Council:

> "Governments set financial targets for the nationalised industries. But customers at present have difficulty in knowing whether they are getting value for money. It is necessary to relate financial requirements, operational performance and quality of service.
> The Post Office and its Unions have entered into agreements which are designed to improve productivity. Customers are

entitled to know how they will benefit. We propose that the Post Office should establish a procedure with POUNC to evaluate the performance of the postal service against agreed yardsticks. Government should agree the procedure and the yardsticks to be adopted. A regular and open procedure to 'audit' the Post Office's performance would, in our view, do more to promote the interests of customers than the present arrangements".

When we review all these controls in this way, a clear pattern begins to emerge. The boards must be deemed to run the industries, and if their performance seems poor in a particular area the following factors may be responsible:

1. Genuine commercial risk
2. Lack of competition reduces pressure for cost-cutting
3. Sheer size means all problems cannot be properly analysed and all policies cannot be properly followed through
4. Political interference

Nothing can be done about the first factor (by definition). Until recently, ministers, select committees and consumers have not been able to exert sufficient pressure to compensate for the lack of competition (or more precisely the fear of going bankrupt). Latterly, however, the imposition of external financing limits does seem to have injected a greater degree of urgency.

Ministers, select committees and consumers have all been interested in analysis and follow-through. However the effectiveness of their contributions have been hampered by their remoteness. The need for analysis and action to curb inefficiency is now acute because cash limits are cutting into the investment programmes. Finally, the extent of political interference may be reduced by greater self-restraint (and there will be less chance of getting away with it if the real issues are more clearly and widely understood).

We conclude from this that the most pressing priority is to do something about the third factor, that is to help the boards get better information and to help ensure that it is acted upon. This will be the purpose of a value-for-money audit.

We develop this further in the next chapter. In this we begin by looking at two other agents of control whom we have not yet mentioned – the Monopolies and Mergers Commission, and the financial auditors. The MMC provides a practical launching pad for VFM audits, and corroborates the nature of the problem. The financial auditors can lend us a method of approach which will work.

CHAPTER 3

THE CASE FOR A VFM AUDIT

By looking at the well-established controls on the nationalised industries we have identified likely weaknesses in the provision of information and procedures for following through management action. These weaknesses are likely to reduce the effectiveness of the industries' services and the efficiency with which they use resources. We concluded that the weaknesses arise partly because of the sheer size and complexity of the industries and that ministers, select committees and organised consumers had not been able to cure them.

The Monopolies and Mergers Commission (MMC) have recently produced direct practical evidence which verifies this view.

The Competition Act 1980 significantly increased the role of the MMC. The change which concerns us here is that, under Section 11 of the Act, the Secretary of State for Trade was empowered to direct the MMC to investigate a number of public bodies, including the nationalised industries. The investigations may cover efficiency and costs; the service provided; or possible abuse of a monopoly situation. The first reference made under this Act was British Rail's commuter services in London and the South East. The report was published in October 1980.

The British Rail Board publicly welcomed this investigation and in many respects their efforts to improve the quality of services and the level of efficiency were endorsed by the MMC. Of particular significance, as we shall see later on, the MMC concluded that "it cannot now be said that the Board are pursuing a course of conduct which operates against the public interest". Nevertheless, a number of very important points came to light and these were highlighted in thirty-six separate recommendations. We summarise the main conclusions below.

British Rail is very large and complex organisation. For the

sake of exposition its structure may be grossly over-simplified as follows. One section of general management, organised into regions, divisions and areas, is responsible for driving the trains and getting the passengers on and off. Another section of functional management is responsible for such things as maintaining the rolling stock, the track and the signals. For strategic purposes, however, the Board sees itself operating in a number of business sectors comprising Inter-City; London and the South East; Other Provincial Services; PTE service; Freight; and Parcels.

Within this structure, the MMC expected to find a financial control system with the following characteristics:–

"(a) the provision of a reliable basis for forward planning and the establishment of business objectives in financial terms;

(b) the ability to establish realistic but demanding budgets for income and expenditure, which accord with business objectives;

(c) a reporting system which gives management regular comparison between budget and actual in sufficient detail and early enough for effective action to be taken as necessary;

(d) for a business providing a range of products or services the ability to budget and account separately for the results of each activity;

(e) the ability to relate resources to the activities in which they are employed."

The MMC identified two major weaknesses. First, the Board did not have sufficient information to exercise strategic control over maintenance of rolling stock. Second, the business sectors shared operational and functional costs, and these had not been fully split among the various sectors. As a result the Board had no sound basis for justifying the financial targets set for each sector. In both cases, the MMC noted that improvements could be made.

The MMC then looked at the quality of service provided. They accepted the physical difficulties involved but felt that some of the problems stemmed from a lack of precise performance targets and clear standard procedures for following up failure to meet them. Significantly, they emphasised the important role to be played by consumers (the TUCCs) "especially if the latter are to play an enhanced role in the public debate on quality of service and 'value for money'."

Similarly, the MMC were sympathetic over the practical problems in attracting and retaining manpower. Once again, however, they noted that in many key areas the Board simply did not have a proper analysis of the situation and they were therefore probably failing to take measures which would help recruitment and would reduce absenteeism and resignations. The MMC were also critical about the efficiency with which the manpower was used. They observed that, historically, progress had been greatest when the trades unions were co-operative; management was energetic and systematic; and when there had been financial pressures. For the purposes of future pay and productivity bargaining, they recommended that management should look more closely at the specific factors which raised efficiency and not allow these to be dissipated in general wage increases.

On rolling stock maintenance, the MMC had the following to say. "Maintenance cost controls are based on control of labour hours with no direct control of material costs. We consider this to be a major weakness which is exacerbated by inadequate or loose coverage of labour hours by properly measured standards. These weaknesses should be remedied as soon as possible."

The MMC looked specifically at the way the Board attempted to match supply and demand. They noted that a considerable amount of analysis had been done. However, they also felt that the Board had been slow to develop and adopt load factor targets, and that in a number of respects they had not been sufficiently energetic in identifying the effects of changes in service frequency or in implementing measures which would reduce costs. They reached a similar conclusion when looking at the related question of fare structures. Thus, for example, they noted that the Board "do not so far have enough evidence to draw any conclusions about the response of passengers to peak pricing or the cost savings of spreading the peak."

In reviewing the Board's approach to investment decisions, the MMC welcomed the increased importance given to strategic studies undertaken to support the Corporate Review. In the light of some of their other comments this appears to be an understatement. They felt that the King's Cross electrification scheme "seems to have been considered with a considerable degree of 'appraisal optimism' and the provision of rolling stock was decidely generous." In respect of the rolling stock investment programme they felt that the Board "did not examine the alternatives with sufficient care".

This summary is only partial. It concentrates on some, but not all, of the criticisms which the MMC made; it understates the very

real difficulties which the Board faces and it ignores many of its successes. We believe it illustrates the sort of problems that are bound to arise in a large and complex nationalised industry, for reasons which we have already stated. By the same token we believe it illustrates the need for a value for money audit.

In the next chapter we shall examine more precisely what a VFM audit would involve in the general case. We certainly believe there is a demonstrable need for some-one to be given the job of making sure the MMC's recommendations are followed up. At the moment no-one is really able to do this.

We said at the beginning of the chapter that the MMC did not think British Rail were operating "against the public interest", and we said this statement was significant. The reason for this is straightforward. If an industry is deemed to be doing something against the public interest, the Secretary of State can, under Section 12 of the Competition Act, order it to draw up a plan which will remedy the situation. If it isn't, he can't.

Because of the way the Act is drafted, this is likely to be a common situation. To condemn a nationalised industry as acting against the public interest is not a step to be taken lightly. The MMC is composed of people of learning and judgement, and it is hardly probable that they will rush into such draconian action just because they uncover precisely the sorts of problems they would expect to find in a large and complex business. It would not be reasonable to expect them to. The unfortunate consequence is, however, that unless some other follow-up procedure is devised their recommendations may not be put into effect.

Whatever this follow-up procedure is, it has to work in practice. If we need a system for making sure people do things we can do worse than study the way a financial audit works.

The purpose of the financial audit is to check that the profit and loss account, and the balance sheet, give a true and fair view, and that proper accounts have been kept. In principle there are two ways of doing this. One way would be to examine all the transactions undertaken by a company; check that they have all been properly recorded; and then check that every single one has been reflected in the accounts. In all but the very simplest cases this procedure would be hideously time-consuming and totally impractical.

The other approach, which is the one actually used, begins with a review of the systems used for recording transactions and preparing the accounts. The efficacy of these systems, and the thoroughness with which they are implemented, can be evaluated by well-tried sampling techniques. The use of samples makes this

a relatively quick process. If the systems work, then it follows that the accounts will be maintained in a proper manner, and the profit and loss account and the balance sheet, which are derived from them, will be basically correct.

This, then, is the first point we can make about a financial audit. Its mechanics are based on making sure that systems work. The resources required are therefore kept to a practical level, whilst the method itself is well-proven to be effective.

The second point we can make is that there are generally agreed principles governing the preparation of accounts and the design and operation of accounting systems. If an auditor says that the system for sales accounting has defects, it is unlikely that he will be acting on a personal whim. On the contrary, he will make his observation because he detects deviations from a set of general axioms upon which informed opinion is agreed. Implicit in the financial audit, therefore, is the assumption that there is a proper way of doing things.

The third point to note is that the financial auditor requires the co-operation of the client staff in two rather different ways. He expects them to answer his questions truthfully; produce documents when he asks for them; and draw his attention to matters of obvious interest to save every-one the time and trouble of him tracking each one down himself. More fundamentally, however, he also expects them to have done their jobs. In any reasonable-sized company he will expect to find that, in the main, proper systems have been installed; that people do operate them reasonably conscientiously; and that the accounts are, broadly speaking, correct. Doubtless he may discover the odd wrinkle. When he does, he normally expects the clients' own staff to sort it out. His role is to confirm that other people have done things properly and, overall, he can only play this role effectively if, normally, they have.

The fourth, and perhaps the most important, point to make is that the financial auditor is independent. This is not just, or even mainly, a safeguard against corruption; indeed the auditor and the finance director frequently share membership of the same professional institute with its common code of ethics. The value of his independence lies in the fact that the auditor is not bound up in it all, and he can take a wholly impartial and impersonal view. This is why he is effective. It is the prospect of his visit which concentrates people's minds, and spurs on their endeavours.

It is generally accepted, certainly in this country, that financial audits are a good thing. Where business men are entrusted with other people's money, it seems reasonable to expect them to produce a periodic account of what they have

done with it and it seems prudent to submit that account to detailed independent review. Moreover, the financial audit is clearly effective. To see that, one only has to contrast this country with those in which the financial audit has not yet been enforced.

More specifically, the financial audit seems to operate satisfactorily within the nationalised industries. There is no serious suggestion that the directors might be helping themselves from the till and, by and large, people accept that the financial accounts are properly kept and presented.

People are less satisfied that the nationalised industries are giving proper value for the money they spend. We have gone further and suggested that it is almost inevitable that they could give better value. We have illustrated this by quoting from an MMC report on an industry which is reckoned to have relatively imaginative and sensitive senior direction. We have suggested that a VFM audit will be necessary to ensure that the recommendations in this, and other reports are properly followed up. Now that we have seen how the financial audit works, we can see how the same approach can be used to make a VFM audit work.

First, it must concentrate on checking that systems are working properly. In the VFM audit, these will be the systems for making policy and controlling resources. In both cases we will want to review the quality of information, used in decision-taking and monitoring, and the vigour with which action is then taken.

Second, there must be generally agreed principles on what constitute good systems. For the VFM audit this means that there must be generally recognised practices of good management, and there must be a broad framework of strategic policy. The former exists, and the latter either exists or can be made to.

Third, the staff of the industries will need to co-operate both in the VFM audit itself and, more fundamentally, in taking the active role in seeking value for money. The former should pose no problem; the latter they are already doing.

Fourth, the VFM auditors will need to be independent. That should not pose any problem.

In the final chapter we look at these matters in more detail.

CHAPTER 4

THE OPERATION OF A VFM AUDIT

We have identified four key points about a VFM audit:

(a) it should be concerned with systems for:—
  (i) taking and implementing policy decisions;
  (ii) monitoring and controlling resources;

(b) there should be general agreement about what constitutes a good system;

(c) the support of the staff is required;

(d) the VFM auditors must be independent.

We shall develop each of these points in a moment. Before we do that, however, we can eliminate a number of possible misconceptions. First, a VFM audit is not a collective term for a series of management consultancy exercises. It is concerned with checking that things are being done, and even suggesting that they ought to be, but it does not involve actually doing them. Second, it does not provide a forum for outsiders to come along and promulgate idiosyncratic views about the industry. The whole emphasis is on nudging people along to do things which they accept that they ought to be doing. Third, the VFM audit in no way usurps the functions of management or sets out to make them look foolish. On the contrary, it will provide positive encouragement to the development of better management practices. It is important that these points should be clearly understood before we now turn our attention to the practical operation of the VFM audit.

The mechanics of a VFM audit can be analysed in five stages. The first stage is to identify:—

(a) the important types of policy decision which the industry takes, and the points at which they are taken;

(b) the main uses of resources by the industry (which would include manpower, fuel and energy, materials, land, vehicles, and equipment, within its various activities), and the points at which these uses are monitored.

The second stage is to agree with the industry on precisely what type of information is needed as a basis for:–

(a) taking the policy decisions;

(b) monitoring the uses of resources.

The third stage is to review the mechanisms which exist for getting the right information to the right people at the right time, in a form which they fully understand.

The fourth stage is to review the management and organisation structure to ensure that it is appropriate for:–

(a) putting policy decisions into practice, and reporting back on progress;

(b) applying the controls necessary to ensure the efficient use of resources.

The fifth stage is to check that, within that management and organisation structure, the appropriate actions are in fact carried out.

It will be seen that the first stage establishes the main emphasis on the VFM audit. The second and fourth stages set a framework for getting information and taking action, respectively. The third and fifth stages involve making sure that things actually happen, for which purpose sampling techniques may be used. It is hardly surprising to note that, in the case of British Rail's London and South Eastern passenger services, the MMC have already undertaken the first, second and fourth stages. In this case, therefore, a VFM audit could move straight into the area of reviewing whether appropriate action has been taken, as indeed we have already suggested.

The next point we need to consider is whether any practical difficulties are likely to arise in getting general agreement on what constitutes good practice. To a considerable degree, of course, this question has already been answered. Where genuine disputes exist, and we expect these to be very much the exception rather than the rule, the MMC are on hand to give impartial and authoritative advice.

There is another reason for our optimism on this point. The sort of VFM audit which we want to see would concentrate on reviewing, and thus improving, methods of approach. It is not conceived in terms of reviewing specific outcomes, to see whether these were 'good' or 'bad'. Thus, for example, we do not think an effective VFM system can be built upon a special external exercise to analyse British Rail's maintenance activities, with the aim of concluding that the material usage is too high or that the men would be better employed mending different types of train. This sort of study has its place but its application is severely limited by resource constraints, and its findings are often controversial. This may stem in part from debate over whether such studies should focus on effectiveness (in meeting general policy goals) or merely efficiency (in minimising waste). Our contrasting approach, as we have already seen, would be to agree with British Rail what information they needed about their maintenance activities, and what sorts of action they should take when they had it. We would then suggest to them that they got on with it, and that the VFM auditors would be popping in from time to time to see how things were coming along. We do not see this approach as being controversial, although of course we do think it might be cheaper and more effective.

There is, however, one specific caveat to which we referred earlier. The VFM audit could run into difficulties if there were uncertainties about such fundamental questions as what the basic purpose of the industry was. For example, it might be difficult to agree on what information was needed to run the business if it was not clear whether it was a commercial undertaking or a social service. Fortunately, these are the sorts of question which can and should be answered by the minister.

The third point to consider is the role of the industry's own management and staff. As we have already said, their primary task is simply to carry out their normal duties so well that the VFM audit reveals that nothing further needs to be done. More specifically, however, we need to review their detailed involvement with the VFM audit procedures. We envisage two types of involvement.

First, we see great advantage in having a small VFM audit committee, formed at board level from both the executive and non-executive directors, and preferably with the addition of a consumer representative. This committee would appoint the VFM auditors and discuss with them the precise scope and timing of the VFM audit. The VFM auditors would maintain close liaison with the audit committee throughout the year and particularly when detailed VFM audit activity was taking place.

Second, we think it would be useful to give a number of less senior and experienced line and functional managers detailed responsibilities for liasing with the VFM audit team and reporting to the VFM committee. These managers would play a key role in galvanising and co-ordinating action within the industry to remedy problems identified during the VFM audit.

The fourth point to consider is who the independent auditors should be and how they should report. As to who they should be

we have already indicated or implied four desirable characteristics. They must be independent. They must be experienced in decision-making processes and control systems. It would help if they were familiar with the work of the Monopolies and Mergers Commission. They should presumably carry a certain amount of conviction when they are appointed.

The obvious candidates under these criteria are the large professional accounting firms. However, we would enter two caveats. There may be a case for using the government audit services, although any objections from the industries about their possible lack of independence would need to be considered very carefully. More importantly, certainly in the early days while the procedures were still new, the audit team might be strengthened immensely if it could draw on support and advice from the Monopolies and Mergers Commission and perhaps an independent industry expert.

On methods of VFM audit reporting, we do not feel it necessary to go into detail. Any method adopted would need to reflect local circumstances and the professional accounting firms, in particular, have extensive experience in these matters. There are, however, certain broad principles which might usefully be followed.

During the course of the VFM audit the VFM auditors would liase closely with the VFM audit committee, and they may well submit one or more interim reports on a fairly informal basis.

At the conclusion of the audit a formal VFM audit report would go to the committee. It would specify the matters that had been reviewed and their significance; it would indicate how the reviews had been carried out and it would reach conclusions as to whether, in the VFM auditors' opinion, the management were operating in a manner which promoted the achievement of value for money. From the committee the report would go to the board who would send a copy, together with their comments, to the relevant Secretary of State. In consultation with the board, he would then delete any confidential information and arrange for the report to be published

CONCLUSIONS

In the first chapter we noted dissatisfaction with the performance of the nationalised industries. We suggested that privatisation; re-definition of the PSBR; and better liaison with consumers, could help improve the situation but not on the scale required.

In the second chapter we indicated that a major factor in the problems besetting nationalised industries was their sheer size and complexity. This made it difficult for the management to obtain all the information they needed to take policy decisions and monitor the use of resources. It also made it difficult for the boards to maintain momentum, in all areas simultaneously, when implementing policy or controlling resources. Ministers, select committees and consumers could not really remedy these problems unaided because they lacked detailed involvement in the working of the industries.

In the third chapter we showed that the Monopolies and Mergers Commission has uncovered precisely these problems in their first investigation under section 11 of the Competition Act 1980. The publication of their report, however, did not in itself guarantee that action would be taken. Accordingly we recommended the introduction of a value-for-money audit to ensure that this was done. We showed how the VFM audit could be based on techniques derived from the financial audit, which had been proved to work effectively and economically.

In the final chapter we explained in more detail how the VFM audit would work, and how it would help to improve performance. We showed that it would be helpful to have an MMC investigation within an industry before the VFM audit was introduced, but that this was not essential.

We believe there is therefore, a strong case for the introduction of VFM audits in the nationalised industries, along the lines that

we have described. We hope that the boards, the ministers, the select committees, the consumer representatives, the MMC and the OFT will give careful consideration to this matter. Ultimately, we feel that legislation will be required. In the meantime, however, we would like to see a start made on a voluntary basis.

As final encouragement towards this goal we quote the concluding paragraphs of an earlier MMC investigation, under the Fair Trading Act 1973, into the Inner London Letter Post.

> "We cannot avoid the conclusion that the various existing controls have had very little success in making the Post Office more efficient. The financial target, as we have seen, is not an effective constraint. The performance target also has limitations. The use of 1977-78 as the base year ignores the previous decline in producitivity and increases in tariffs. Greater information on real unit costs for the different services, i.e. inland letters, overseas letters, parcels and counter services, and for the different regions would be helpful but the lack of work measurement and cost allocation system at present precludes this. POUNC has had little influence on Post Office policy. Despite progress in implementing some recommendations previous inquiries have had little effect on efficiency in the London Postal area. Both the management and the Union of Post Office Workers told us that the very existence of our own enquiry had been a factor in the progress that was being made towards the introduction of bonus schemes which may, we hope, result in the achievement of increased productivity. We believe, however, that real progress will be made only if satisfactory additional procedures to monitor progress can be introduced.
>
> Previous inquiries into the Post Office, as we have observed, have resulted in little progress. If our recommendations are accepted it will be essential that the Post Office makes, and that the Secretary of State ensures it makes, a determined and lasting effort to carry them out. It seems to us that the first step must be for the Secretary of State and the Post Office together to work out a time-table for the introduction of the necessary changes, and a system for regular reporting by the Post Office of progress made. The Secretary of State will then be in a position to ensure that our recommendations are carried out in accordance with the time-table."

MATRIX

of

CONTROLS

	Financial EFL Est Out-turn	Asset Sales	Private Capital	Performance Monitoring	Competition
BNOC		Sale of Oil Bonds to small savers. Forward sales of oil May sell Equity		Average annual rate of return (after CCA depreciation but before interest and tax) of 9% on net assets valued at current cost April 1980-March 1983.	Already competitive in most areas
ELECTRICITY 1980-81 1981-82	EFL increased to lower energy prices and allow for impact of recession 187 175 -165	None	None	1.8% on CC net assets 1980/1 to 1982/3	Stated intention to permit competition in generation.
GAS 1980-81 1981-82	EFL increased to lower industrial energy prices -400 -400 -319	None	Possible Private capital with BGC participation in new Gas Gathering system	6% on net CC assets 1979/80 to 1981/2	No changes in monopoly of any importance OFT enquiry into Gas retail showrooms
COAL 1980-81 1981-82	EFL increased to prevent pit closures 834 832 886	None	None		No charges in monopoly over coal reserves
FREIGHT 1980-81 1981-82	24 11 7	Transport Act 1980 enables Minister to sell equity and re-linquish control	N/A		Competitive
NATIONAL BUS 1980-81 1981-82	Consideration being given to debt cancellation EFL exceeded 85 85 75	None	None		Increased competition in coaches and in special deregulated areas
BRITISH RAIL 1980-81 1981-82	EFL increased 750 790 920	None	Non rail companies created under a holding company umbrella to allow introduction of private capital		Competitive in non-rail businesses
DOCKS 1980-81 1981-82	-10 -10 -5	Minister has proposed sale of 49% of BTDB	N/A		
AIRWAYS 1980-81 1981-82	EFL increased owing to decline of profits 230 304 101	Civil Aviation Act 1980 allows sale of shares. Sale delayed	N/A		Competitive on international routes
TELECOMMS (POST OFFICE) 1980-81 1981-82	65 -137 180	None	Private Capital may be introduced via Bonds	5% on av. net CC assets 1979/80 to 1981-82	Some increase in competition under 1981 Act
POST 1980-81 1981-82	See above 16	None	None	2% of turnover (after depreciation and interest) 1980/81 1982/83	Monopoly can be suspended under the Bill
CABLE & WIRELESS	N/A	Sale of company proposed for the autumn	N/A		Competitive
BRITISH AEROSPACE	N/A	52% sold in February 1981	N/A		Competitive
BRITISH SHIPBUILDERS 1980-81 1981-82	EFL increased 120 165 150		Manifesto pledge to denationalise	Loss limits for last 2 years (exceeded in practice)	
BRITISH STEEL 1980-81 1981-82	EFL increased Capital reconstruction approved 450 1,121 730	None	Joint companies with private sector	Possibility of break-even postponed	Competition being reduced
BL	Cash support increased	None	Honda joint venture		Competitive
RR	Cash support increased	None	None		Competitive
GIRO				13% on net CC assets 1979/80 to 1981/82	