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CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

BRITISH RAIL FINANCES

Memorandum by the Minister of Transport

1. Under Sir Peter Parker, the British Railways Board (BRB) have since 1976 kept within the financial limits set them. He regards these limits as an important management instrument. The perennial railway financial problem has been contained, and the level of the Exchequer support reduced by over £100m to 1979. There are still very important improvements in business performance and productivity which we must look to BRB to secure. But we cannot suppose that after five years of relative stringency there are any easy savings still to be made. Indeed, there is now real ground for concern that spending on track and infrastructure has been cut back too much.

EXTERNAL FINANCE LIMIT 1979/80

2. In June last year we reduced the external finance limit (EFL) for BRB by £15 million (from £730 million to £715 million). BRB managed to stay within the reduced limit, finding means to offset adverse factors which included heavy rises in their fuel costs, and part of the impact of the BSC strike. But, effectively, they pushed at least £10m over the line into the current year.

EXTERNAL FINANCE LIMIT 1980/81

3. For the current year we set BRB an EFL of ~~£770m~~ 750 (£660m of this is grant) and that was some £50m less than their forecast. Sir Peter Parker has repeatedly reaffirmed his commitment to do all he can to live within this limit. But the financial effects of the steel strike, the heavy erosion of all their major traffics by the recession, and cost increases (including a pay settlement costing about 18% in the financial year) have been more than they could contain within the EFL. Savings from tight manpower budgets, train mileage cuts, higher property sales and deferring investment should more than offset the excess cost of the wage settlement. They are increasing passenger fares by an average of about 20% on 30 November. But even so, the Board are now forecasting that they will overshoot the EFL this year by £68m, further losses of traffic are possible, and the scope for further economies is effectively exhausted.

4. In the circumstances, I have agreed with the Chief Secretary that the Board's EFL should be increased by £40m to £790m. This will set a very tough, but not impossible, limit to which the Board must work. Any excess over this level would have to be offset against the EFL for 1981-82.

INVESTMENT AND FINANCING REVIEW

5. For 1981-82 we can, in my view, take a more stringent line. Last year we asked the Board to manage within a declining level of external finance. My objective was to ensure that by 1983-84 while still receiving grant towards the cost of their passenger services they would meet all their other needs from internally-generated finance. The Board's latest projections suggest that this target is in danger. The background is discussed fully in Annex A. I remain very unwilling, however, to concede any relaxation until I have received and considered various studies due to come to fruition later this year. I am particularly unwilling to any general relaxation either of investment ceilings or financing figures for 1981-82.

6. To leave the financing figures for 1981-82 as they stand will entail further cuts in train services with increased over-crowding for commuters as well as continued acceleration of asset sales. If the EFL for 1980-81 proves insufficient and there is carry over to 1981-82 the pressures on the Board will be extreme. But to maintain the present limit will also put pressure on the Board to contain next year's pay settlement within single figures and this seems to me of overriding importance. My belief is that, given a taut pay settlement, the Board should be able to manage within such a limit without disproportionate rises in fares and I would propose to put this view strongly to Sir Peter Parker.

COLLECTED AND DELIVERED PARCELS

7. In one respect however I believe we should offer some easement in 1981-82. The Board's collection and delivery service for parcels has long been known as a heavy loss-maker. They have hitherto planned for a relatively slow rundown with continuing losses cross-subsidised from more profitable operations. The Board have felt constrained to this course because they could not otherwise finance the initial transition costs of £40m to £50m and the risks of major industrial disruption even though closing the operation should produce an improvement in their cash flow of over £30m per annum in later years. After consulting the Treasury I have assured them that we would sympathetically consider special provision for meeting these transition costs although this would need to be fenced off from the EFL. I have therefore proposed to the Chief Secretary to make available earmarked loans up to £50m to cover these costs in BRB and the National Freight Corporation (which provides the cartage). If things go smoothly the amount needed in 1981-82 should not exceed £30m. I am sure this is the right course, but my colleagues should be aware that job losses of 4,500 in BRB and 2,300 in NFC are involved, and risks of major and costly industrial disruption.

PRIVATISATION AND INVESTMENT

8. These proposals will set the Board extremely difficult tasks. I have therefore looked for ways in which I might reinforce the discipline of the EFL. The main resource open to me if the Board appear to be in danger of overrunning their revised limits will be to defer major investment projects such as the Advanced Passenger Train. To defer economic investment could be damaging both financially and, possibly, politically. However, I would be prepared to use my powers over investment on the basis that the Board could win back any such cuts by bringing forward into 1981-82 major disposals such as that of their hotels at present planned for later years. It seems to me reasonable to face the Board with these alternatives if they fail to contain their call on public finance by other means.

9. I therefore invite my colleagues:

(a) to note the increase of £40m which I have agreed with the Chief Secretary in the EFL for 1980-81;

(b) to make no change in the volume investment and financing figures for BRB for 1981/82;

(c) to note that I propose that any further overshoot by BRB in 1980/81 should be recovered in 1981/82 by deferring investment until it can be financed by additional asset sales;

(d) to agree to a special provision, outside the EFL, for borrowing of up to £50m in 1981/82 solely for the purpose of covering transition costs in withdrawing from the collection and delivery of parcels.

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Department of Transport
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12 September 1980

INVESTMENT AND FINANCING REVIEW

1. Last year we provided for a sharply declining level of external finance for BRB, falling by some £53m from 1981/82 to 1983/84 so that by the latter year the Board, while still receiving a large passenger grant, would have been meeting all their other needs from internally generated finance. This improvement was to be secured partly from a somewhat better result in the passenger business but mainly from major productivity improvements through demanning in the freight business, and without providing for any of the additional investment for which BRB were urgently arguing. Early this year I settled with the Board challenging financial targets for the Inter-City and freight businesses to reach by 1982, in line with these projections.

2. The Board have now given me a new forecast of financing requirements for 1981/82 and the following years, taking account of their latest traffic projections and of the economies so far quantified flowing from measures already decided onto cut back. The forecasts include their earlier bid for more investment; but are on more recent appraisals of traffic prospects and businesses changes than the figures in the Review. The railway certainly faces increasing problems from the deferred renewal of their equipment, but I do not think we can make a judgement on that now. Excluding the Board's additional investment bid, additional investment for improving the Victoria-Gatwick service, and financial assistance with the parcels closure (see paragraph 13 below) the new forecasts are for an increase above existing provision of £59m in 1981/82 (1980 survey prices) and £95m and £60m in the two following years. The overshoots arise on both the passenger and the non-passenger businesses.

3. I have specifically reviewed with the Board the prospects for the freight business. They now forecast carryings in each

of the next two years below the level achieved in 1979. Next year and the year after the traffic is now expected to fall some 9 per cent below the forecast the Board were working on as recently as the beginning of this year. The Board are still planning to achieve their financial target for freight in 1982, but the path to it will be much steeper, and progress is still crucially dependent on business changes, following this year's pay agreement, to give major manpower savings, and on the demand recovering somewhat from current levels.

4. The Board have not resiled from the financial target for Inter-City for 1982, but it is proving much more difficult than they expected. In November there will be substantial <u>real</u> fare rises on Inter-City, and this may have to be repeated in future years - a risky strategy when the recession is cutting into the valuable business market for first class travel, and when the railway could face increased competition from the coach services.

5. In view of the uncertainties, and the longer-term studies I refer to below, I suggest we should not try to settle now on any new figures for 1982/83 onwards, though given the Board's forecasts I cannot undertake to keep them to the existing provision.

OPTION FOR 1981/82

6. I must avoid any pressure on BRB to reduce expenditure on track and signalling, which has already been cut to the bone. I judge however, that I can reasonably call on them to make further economies in train services, and refurbishment of the stock, to save at least £10m-£15m, though this may mean increasing the loading on some commuter trains. Second, they should also be able to reduce their finance requirements next year by additional asset sales of at least £10m-£15m.

7. The forecasts for 1981/82 contains assumptions, made before the Chancellor of the Exchequer's meeting with the chairmen of the nationalised industries, that the basic wage settlement next year may be 2½% below the movement in the cost of living, with a productivity payment of 3% in addition. Both these figures must now seem generous, and the productivity payment would be significantly more than the value of the manpower reductions incorporated in the forecast. Discounting for both of these factors would reduce the 1981/82 forecast overshoot by at least £40m. I would not wish to slacken in any way the pressure on them for these purposes.

8. There are accordingly ways in which the Board should be able to keep within the existing provision for 1981/82, but this depends crucially on the pay settlement and on progress with productivity changes. In putting this to Sir Peter Parker, I would further say that I judge the figure should enable him to hold fares for a full twelve months. If, in the event, the interval were reduced to eleven months, as this year, some £12m could be gained.

LATER YEARS

9. Action on parcels of the kind the Board now have in mind should substantially improve the figures for later years, which are also much dependent on BRB's ability to make progress with other business changes to improve productivity. In this uncertainty, it would be pointless to form a fresh judgement of them now. But I shall have to consider much fresh material relating to railways - in particular the report from the Monopolies Commission on the London commuter services, which we have just received; the report we shall shortly have on the case for main line electrification; and the Board's own reviews of the future of their passenger and freight businesses. Given the importance that I have throughout attached to avoiding any major programme of closures of rural services, Sir Peter Parker has emphasised to me the need to examine together the longer term on the basis of his new Corporate Review and I propose to do this with him

during the autumn. I will then bring my conclusions to my colleagues early in the New Year.

PRIVATISATION

10. The situation that we face is accordingly one in which it should be possible for the Board to live within existing provision for 1981/82, if major disruption can be avoided, progress can be secured on productivity changes, and an excessive pay settlement avoided. But there are not opportunities to recover what must now be seen as an inevitable overshoot for 1980/81. I have proposed an adjustment in recognition particularly of the rapid loss of freight traffic. This should help retain the determination with which Sir Peter Parker and his Board have sought to live within their financial limits. However, I have not suggested that we can take on the whole of the overshoot. I have considered other options.

11. The figures above take no credit for any proceeds of privatisation. It would in my view be premature to bank on being able to float Sealink in 1981/82 given that this year and probably next year will show poor results from the recession. But we should not exclude the possibility. Further, the Board are considering options for early sale of some or all of the hotels. They may not in fact have power to sell the entire business until next Session's Transport Bill is on the Statute Book. Finally, the Board may have opportunities, not yet realised, to sell developed properties.

12. The other option would be to reduce the total of investment in 1981/82 by deferring projects that would otherwise start. These include substantial advance expenditure for the main build of the Advanced Passenger Train, as well as new ferries for the main ferry business. We have so far been able to maintain the position that we have not reduced the ceiling on railway investment below that set by the previous Government and this is helpful to us politically. Moreover, we have said that in a situation of the kind we now face we would seek to avoid restricting profitable investment programmes.

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13. However, I have concluded that we cannot ignore the investment option, and that it would be valuable to demonstrate to the Board, to the Unions, and the public that we are not prepared to put up more money simply to finance a deterioration in the business. I therefore propose that I should tell Sir Peter Parker that (assuming their existing forecasts for the economy and no substantial disruption) any overshoot on the EFL this year above £40m will have to be recovered by additional sales of assets in the next financial year, and that I shall so exercise my power to approve investment projects particularly in the commercial businesses as to secure that commitments to fresh investment proceed only so far as they can be financed in this way. This will of course put the Board under further pressure to minimise the overshoot this year.

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