PO-CH/NL/0880

PART A

Part . A .

CONFIDENTIAL

(Circulate under cover and notify REGISTRY of movement)

Begins : 26/2/88

Ends : 25/9/89.

PO -CH /NL/~~0153~~ 0880

PART A

PO -CH /NL/~~0153~~ 0880

PART A

Chancellor's (Lawson) Papers:

PRIVATISATION OF BRITISH RAIL

Disposal Directions : 25 Years

[illegible]

Material used by Official Historian DO NOT DESTROY

Interesting: [illegible] advice. Obviously many problems, but I would have thought regulation is the problem: there is so [illegible] attract competition from road etc.

Ch/ To be aware (ppr. has gone to FST). PM is not seeing this until next weekend - there is scope for putting in Tsy. comments when we get advice. 25 26/2

SECRETARY OF STATE FOR TRANSPORT

CH/EXCHEQUER
REC. 26 FEB 1988
ACTION FST
COPIES TO

26/2

CONFIDENTIAL

PRIME MINISTER

FUTURE FINANCING OF RAILWAYS

26/2/88

Great Eastern Railway Co

1. Since my arrival at the Department of Transport, I have become acutely aware that we lack good long-term policies for both British Rail and the London Underground. Despite the advances that they have undoubtedly made in recent years, they still bear the hallmarks of a state-controlled industry: they are both monolithic, bureaucratic, and slow to respond to the needs of the customers. It must be right for a radical, reforming government to look seriously at privatisation of the railways.

The rebirth of Southern Railway!

... 2. I enclose a paper on the subject, which suggests that there could be real options in the early 1990s for privatising the London Underground, the Southern Region of BR, the Anglian Region of BR and a "core" commercial railway broadly between London, Glasgow and Edinburgh. London, Midland & Scottish

3. On the analysis that has been possible within my Department, these options look a good deal more promising than one might have imagined, bringing with them substantial benefits to the consumer. But we have to handle the matter with the greatest care.

4. The gains from privatisation could be considerable, not only in efficiency and productivity. We have to look forward to a time in which a number of railway companies can offer modernised railways benefitting fully from advances in technology to customers who will be finding the roads increasingly congested. That should go with the significant advantages to customers from flexibility and innovation that a move to the private sector should encourage. If we can get this right, private enterprise may well find opportunities to develop new services - even whole new concepts. Our problem is to get that picture accepted,

SECRETARY OF STATE FOR TRANSPORT

CONFIDENTIAL

without running straight into a 'hands off the railway' campaign, and this points to trying to develop a step-by-step approach. (We would of course at some point need fresh legislation, but that is some way ahead).

5. We shall need to be able to offer reassurance on several points. The first is that a satisfactory regime of regulation can be devised, to constrain fare increases and promote quality in those cases where railways still have a significant monopoly. The second is to show that we can have mechanisms of obligation and subsidy (in some cases tapering) so that privatisation would not precipitate unacceptable changes. The third is to show that privatisation would help rather than hinder the major investments that will be needed, for example for growth in Channel Tunnel traffic, or for increase in travel to work in the City.

6. I would have liked to start by pushing ahead now with ideas for privatising the Underground, where we can expect good support from Sir Keith Bright and the Board of London Regional Transport, and where it may be most straightforward to develop opportunities for employee participation. However, such ideas have to be put on one side for the present, until we see where we stand following the Inquiry into the King's Cross fire.

7. It is much more difficult to carry forward the investigation of possible options for British Rail, for that depends on information that is internal to BR. We do not want to start committing ourselves to privatisation ideas, if crucial difficulties might emerge later of which only BR could warn us now. Equally, one would like to see positive ideas emerging within BR. I can seek to carry Sir Robert Reid privately to agree to some further examination of the options, but I know that he would be very strongly opposed to any idea of breaking up the national network. We may therefore not be able to make much

progress until a new Chairman is in place to succeed Sir Robert Reid in April 1990 on present plans. There is however one aspect which we could start to canvass without directly raising the issue of the integrity of the network, provided we can get the timing and preparation right. That aspect concerns the possible forms of regulation and subsidy needed for private sector railways. It has of course already been dealt with in one case - as to regulation - for the Channel Tunnel, and is being carried forward in the plans for the private sector to build and operate a light rail system in Manchester. We could move towards generalising these examples.

8. To carry this forward, I therefore envisage the following steps:

a. We will continue to search for small free-standing examples like Manchester LRT where private ownership can be developed; the building of a new connection to Heathrow might be an opportunity, and possibly certain existing lines;

b. I understand there is soon to be a pamphlet from the Centre for Policy Studies, and this may stimulate a good deal of discussion in Parliament and the media;

c. If this leads to pressure for development of new ideas, we could respond by setting out some of the issues on regulation, public obligation and subsidy that would need to be resolved, and suggesting that these require fuller examination;

d. If appropriate, I would at the right stage seek to secure Sir Robert Reid's support for this investigation in principle. This would not be until after BR's pay settlement;

SECRETARY OF STATE FOR TRANSPORT

CONFIDENTIAL

e. Timing is all important. Naturally, I would keep closely in touch with you to ensure we find the most suitable moment to advance each stage;

f. We will plan the future composition of the BR Board, and a search for the next Chairman, with the privatisation possibilities in mind;

g. We can return to the question of the Underground after the King's Cross Inquiry has reported.

9. I should welcome your views on whether we should develop a plan on these lines for starting to open up these issues carefully and progressively. I am conscious that all this is very sensitive territory and I am copying this at the present stage only to the Chancellor of the Exchequer.

10. Would you care to discuss?

PC

PAUL CHANNON

26 FEB 1988

2

CONTENTS

FINANCING OPTIONS FOR THE RAILWAYS

SUMMARY

1. The financial performance of both BR and London Underground has improved considerably in recent years, though there are significant gains in efficiency still to be made. The industries are still hampered by a public sector ethos and this raises the question of whether some form of privatisation would be possible or beneficial. Private sector involvement would entail both **regulation** of those services where the railways have a dominant market position, such as the Underground and BR's London commuter services and **subsidy** to ensure that loss-making services continue to be provided, where that is appropriate. Capital grants might also be needed to underpin very large new investments which would be needed to cater for rapid growth in employment in London.

2. This paper considers a number of privatisation options and methods. It concludes that

- total privatisation of British Rail is not an attractive option, it would remain a monolithic organisation making significant losses and requiring detailed regulation. Privatisation is unlikely to offer much improvement compared to the current organisation. (paras 17-18)

- other solutions suggested for the railway as a whole, such as a Government funded Track Authority with the private sector operating the trains raise major problems of control and incentives; while these may merit further study this does not seem to be the best way forward. (paras 22-23)

2

- significant parts of the rail network could be made profitable and attractive to the private sector and offer the most promising prospect for outright privatisation. They include a large part of the London Commuter Services, and the core of BR's InterCity and Freight network. (paras 35-53)

- for the remainder continuing heavy subsidy will be necessary but there may be efficiency gains to be achieved from involving the private sector through franchises or concessions. (paras 54-64)

- it would be possible to privatise the London Underground at an appropriate moment, subject to further work being done on the necessary regulatory regime.(paras 67-79)

2.

PART I: INTRODUCTION AND GENERAL PRINCIPLES

3. This paper explores the scope for fundamental options for shifting the railways into the private sector. It discusses in turn:

- the advantages of privatisation
- the constraints which arise because of monopoly (in some situations), the need to retain some public obligations (for social reasons) and the provision of continuing subsidies.
- the possible forms of privatisation
- the options for British Rail
- the options for London Underground.

2

4. The financial performance of both BR and LUL has improved considerably over recent years. BR's PSO grant requirement fell from £980m in 1983 to £714m in 1986/87, a reduction of 27%. The latest forecasts indicate that BR should be able to improve on their further objective to reduce the grant to £555m in 1989/90. The InterCity business will be ineligible for grant in 1988/89 and a target has been set for the commercial sectors (including InterCity) to achieve a 2.7% current cost profit before interest in 1989/90. Since 1983 there has been substantial income growth, increased passenger miles, reductions in manpower but no major

reduction in basic operating costs. There has been only limited improvement in quality of service over the period. New quality of service objectives were set in July 1987 covering punctuality, cancellations, customer inquiry response times, train cleaning and overcrowding. These will be closely monitored.

5. The London Underground's improved financial position reflects increased demand and a reduction in its unit costs of production (by 4.7% in 1985-6 and 5% in 1986-7). Passenger receipts as a proportion of operating expenditure has grown from 94.5% in 1984-5 to 115.7% in 1986-7 and as a proportion of total costs, including depreciation and renewal provisions, from 70.4% to 79.8%. Under the new objectives discussed with LRT, these improvements should continue, and quality of service targets would be met. But both BR and LUL have some way to go in introducing satisfactory business management and information and control systems.

Potential Gains from Privatisation

6. Despite these improvements, many inefficiencies and restrictive practices remain within the two organisations and the general performance of management is below the level required to operate such businesses efficiently. In theory improvements in performance ought to be achievable with the railways in public ownership, but in practice it is difficult to sustain the necessary management freedom and generate an entrepreneurial ethos.

7. The major gains for the customer and the taxpayer are likely to be as follows:-

a. a private operator would get closer to his customers and would be more innovative in marketing, matching supply more closely to demand, and improving the product to meet passengers aspirations - so for the consumer there is the prospect of a better railway;

b. a private sector owner would insist on holding managers fully accountable for financial performance and would have the freedom to pay appropriate rewards

c. if privatisation is to involve splitting the railway into smaller units then it will offer the opportunity to escape the penalties of nationally agreed pay rates;

d. a private sector manager would have a tougher attitude on costs and would find it imperative to simplify the negotiation and consultation procedures with the unions and to modify the labour contracts so as to make better use of labour;

e. there would be a greater incentive and fewer constraints to introducing more flexible pricing policies;

f. there would be a greater incentive to search out and exploit wider trading opportunities.

8. It is not possible to put a figure on the potential efficiency and financial gains which are available. There are few private sector railway operators anywhere which can readily serve as comparators. From experience of privatisation in other sectors of the UK economy, one can expect considerable benefits from the greater incentives to management, from liberating management from public sector controls and from requiring them to raise their capital on the market. As a general principle, the greatest efficiency gains from any privatisation are likely to arise from increased competition, or threat of competition, and some from 'competition by emulation'. Without this spur, there is the risk that the influence of shareholders on management may be too limited.

9. One of the questions to be considered in this paper is the extent to which competition already exists or can be introduced: or if it is not possible, because of the "natural monopoly" conferred by the track, how far is it practicable to increase the efficiency incentives for the supplier by making him compete with other potential suppliers from time to time for a licence to continue to operate.

Regulation and Subsidy

10. The privatisation of rail services would require careful consideration of the necessary framework of regulation within which private sector companies would operate. It might need to vary from one part of the railway system to another. The Government might also wish to place obligations on private owners: these might, according to the case, include an obligation to provide services in early or late hours, to be a public carrier without discrimination or to carry a particular traffic (eg old age pensioners).

11. Where the rail system has a strong market position, so that the operator could exploit monopoly power, it will be necessary to regulate him. This would be the case for example in the London commuter market, where it might well be desirable to consider a ceiling on fare levels simply to inhibit the exercise of monopoly power; the ceiling could be related to an index of the cost of coming into London by car. Another example of monopoly is where trains from one operator need access to the tracks of another; the charges for that should preferably be settled by agreement, but an external regulation may be needed as a fall-back.

12. There may be circumstances where the operator should be kept under a public service obligation. For example, on the Underground he might be required not to close any stations and to operate on Sundays; it would be for further examination whether the obligation should be more tightly defined, and whether there should be standing arrangements for varying it (other than the opportunity for the operator to promote private legislation for that purpose).

13. There may be cases where there are external benefits from rail services (for example relief of road congestion in London) to the degree that subsidy ought to be paid to secure them - whether for new capacity or for constraining fare levels at peak. Such subsidies would need to be specifically tailored to the objective, and contractually agreed. There might also at the start be a need for a tapering subsidy, depending on the date of privatisation.

14. Such matters of regulation, obligation and subsidy are not a bar to privatisation. But they require care to see that the new owner has sufficient incentives to operate efficiently and cannot simply pass on the costs of inefficiency to Government, and that regulation and obligations are limited and clearly defined, so that the private sector operator is left with maximum freedom to exercise his initiative.

2.

PART 2

THE OPTIONS

15. We should consider a number of possibilities:-

a. leaving the railways in the public sector but contracting out more activities to the private sector;

b. private ownership of the railways in their present form or

c. as regional railways;

d. private train services on publicly owned lines ie a track authority;

e. franchising with relatively short term contracts to provide specified services;

f. concessions with long term contracts and some obligations.

In the following paragraphs, each of the above options will be examined in the light of the objective of creating cohesive management units which are financially viable if possible and to obtain the greatest efficiency improvements. Ideally the organisations should have reasonably self-contained cost structures and effective spans of management control. Wherever possible monopoly elements should be minimised and maximum opportunity taken to create competitive market structures. This may mean applying different arrangements to different parts of the BR network and the Underground. This is considered in more detail in Part 3.

Public ownership with contracting out to the private sector

16. BR has been increasing the amount of private sector contracting and we can expect that further steps will be taken to increase the range of involvement. Ideas which have been discussed include:

- faster and wider development of station retailing
- the introduction of more private catering
- greater use of privately owned rolling stock for certain services
- private sector investment in Freightliner (BR's container subsidiary)
- private sector involvement in track maintenance.

These developments are to be encouraged but they are unlikely to have a fundamental impact on BR's overall efficiency. More radical options need to be examined.

Privatisation as a whole

17. In theory the railways could be sold in their present form, made subject to regulation but also benefitting from subsidies from the Exchequer and local authorities. But while some gains might arise from the change of "public image", some of the underlying problems we face at present with BR would remain. The privatised railway would be a mixture of profitable (or potentially profitable) services and others that were hopelessly uneconomic and requiring very large subsidies. The risk would be that the organisation would be too large and diverse and that financial disciplines in the commercial parts of the business would be undermined by the need for large subsidies elsewhere. There would be no competition (even by emulation) between

2.

different parts of the rail system. It would be difficult to ensure that the new owners had a real prospect of a profit on their investment and at the same time transfer from government the risks and costs of continuing to provide guaranteed services. A large "dowry" would be needed.

18. **We do not recommend this course.**

Regional Railways

19. One way of overcoming these drawbacks would be to split up the present BR either geographically (eg; based on the old pre-nationalisation companies) or into self-contained businesses and to privatise those. This would have the advantage of reducing the scale of the business -and therefore making it less unwieldy- and would fit part of the existing management structure.

20. Reorganisation based simply on BR's present regions would not however be wholly satisfactory; some of them contain a widely disparate collection of services - a mixture of freight, high quality inter-urban and local services. They would run the risk of turning into BR-in-miniature, complex organisations without a single coherent objective, requiring detailed regulation to ensure that subsidy aimed at poor performing services did not seep into other activities. Many of the advantages which have been gained from developing the Sectors as the key business unit in the railway would be lost. The present regions may provide a suitable structure where the organisation is geographically compact and serving mainly one market, such as BR's Southern Region; its objectives would be clear and the regulatory regime relatively simple. But where there is a broader mix of services of varying profitability it is likely to be better to seek a new geographical grouping which disentangles the commercial businesses as far as possible from the very heavy loss makers.

21. **Privatised regional railways may be appropriate in some areas, such as the Southern, but it it is not a universal solution.**

2

Private services on public lines

22. There has been much interest in the idea of separating the ownership of the track and signalling and other infrastructure assets (which would remain in the public sector) from the ownership and operation of the trains themselves (which would be privately run and purchase 'paths' from the track authority). This proposition has a number of problems:

- the costs of the infrastructure are crucially dependent on decisions which would be in the hands of the operator eg the speed, weight and design of the trains, but not enough is known to reflect these exactly in charges;

- many investment decisions would inevitably concern both infrastructure and operating assets. For example, most of the costs of electrification would fall on the track authority but the benefits would accrue to operators in the form of lower locomotive maintenance costs.

- private sector companies operating on the same stretch of line would be totally interdependent - a delay to one company's train would delay those of its rivals.

- the track authority would not be involved in marketing rail services to final consumers, so it would have little incentive to operate efficiently or react to market changes.

- the track authority would in effect allocate costs between operators. No system of prescribing the principles of charging is likely to be robust enough to be capable of being tested in the courts, especially because it would always be very uncertain what the track costs of individual or marginal trains are, and investment on particular stretches of line is very lumpy and must be averaged out over a number of years and possibly over other parts of the system. So there would need to be a regulatory agency to determine maximum charges and to referee obligations and the allocation of costs to operators and to ensure the efficiency of the track authority.

- the BR costs of track signalling and control are about £750m per annum to which would have to be added a substantial management cost for settling and collecting charges and dealing with a regulator, as well as provision for depreciation and amortisation. Loss of efficiency in distancing this large volume of expenditure from business imperatives might significantly offset gains in efficiency from transferring train operations to the private sector.

- it would divide the responsibility for safety.

23. **The idea of a track authority and private sector operation of the trains is interesting but our present view is that it raises too many difficulties.**

Franchising

24. Franchising shares many characteristics of the private operation model: it would involve letting a contract to a private sector operator to provide rail services for say 5 or 7 years, after which there is a new competition. There are problems of 'capture' - once the franchise is let, the franchisee could be in a strong position to renegotiate better terms. However many railway assets - and therefore decisions - last for much longer than a 5 or 7 year franchise and there would be a requirement for a body -an Asset Authority- which would own and invest in those long life assets.

2.

25. The Asset Authority would be inherently monopolistic, so it would need a considerable degree of regulation. It would be responsible for track and rolling stock assets but would not be marketing or operating services, so it would have little incentive to be efficient: on lines where the services were loss-making, it would be in a strong position to push any increased costs through to the Government. The costs of very expensive lines would be sharply exposed. The Government would probably have to do the regulating itself; and would be authorising and funding investments in track renewal on assumptions about what private operators would be doing over the next fifteen years.

26. **Franchising may be a solution in some circumstances. Further work is needed.**

Concessions

27. Eurotunnel hold a concession for the Channel Tunnel. At the end of the concession the property reverts to the State. Eurotunnel is under an operating obligation (a minimum of one shuttle train per hour throughout the year). If Eurotunnel fail to perform, the concession reverts to the State.

28. The Eurotunnel experience shows that to set up such concession requires a very detailed negotiation of very long-term contracts. But it also shows that the concession concept for involving private capital is workable. There seem to be two limitations. The first is that the railway should be relatively self-contained with very little inter-running or multiple use of the track. Much multiple running would generate the need for a separate track authority. But there are examples of reasonably self-contained railways; the "Drain" from Waterloo to the Bank; the proposed Manchester LRT; the lines to Southend; the Isle of Wight railway; the Docklands Light Railway when complete; the London Underground. There are probably other examples within British Rail. Even a few "concession" railways would be helpful to efficiency, if they offered a salutory demonstration of what could be achieved by different management.

29. The other limitation is the extent of the obligations put on the concessionaire. Obviously he cannot divert the railway to other uses. But if he is subject to onerous conditions on providing a service, and particularly if the equipment is to revert immediately to the concession-giver on failure of performance, then it may be very difficult for the concession-holder to raise finance. For example, on the Bank extension of the Docklands Light Railway we sought to get the railway financed and built by the Canary Wharf Consortium; but because we thought it essential to be able to maintain continuity of operation, we sought to require that if the Consortium failed to operate the railway, LRT should be entitled to takeover at

once and operate it themselves. That was asserted by Canary Wharf to be too difficult a condition to meet. So much would depend on the judgement the concession-giver made about how essential it would be to be able to maintain uninterrupted operation. That would also be important in resisting attempts by the concession-holder to renegotiate the contract on more favourable terms.

30. Concessions may be an apt solution in some circumstances: further work is needed.

14

2

PART 3: CHOOSING THE BEST OPTIONS:-BRITISH RAIL

31. Once BREL has been privatised, BR will have been reduced to a more or less "pure" railways operation though it operates in many different markets:-

i. Inter-City has the potential for commercial viability and is subject to strong competition but there are difficult problems of sharing the costs of infrastructure (mainly signalling and track) with other businesses, particularly freight;

ii. Network South East has some monopoly power over its "captive" commuter market and even though it is some way from being commercially viable, it is the one business where subsidy is conceivably justifiable on the grounds of relieving traffic congestion;

iii. the Provincial Sector is heavily loss making but line closures are politically difficult;

iv. Freight includes several different categories of business such as coal, aggregates, steel, Freightliner and Speedlink with widely varying levels of profits or losses.

32. With such a wide diversity of services and performance no single solution is likely to be suitable for the whole of BR. There are different problems both in different parts of the country and among the various businesses. Thus a package of solutions would seem to offer the best chance of maximising efficiency gains and, where continuing subsidy is inevitable, improving the transparency of subsidy decisions.

33. In devising such a package the object has been to identify those major parts of the railway which are both managerially coherent and have a prospect of commercial viability: these are candidates for outright privatisation. There are advantages in selecting units which are as large as possible whilst retaining coherence, since larger units will tend to be less dependent on shared facilities.

34. For the remainder, which will continue to make losses, franchise or concession agreements offer the most promising route for involving the private sector and therefore the paper seeks to identify networks which are reasonably freestanding and which a private sector operator would be able to manage effectively.

PRIVATISATION CANDIDATES

35. The Anglia and Southern Regions of BR could be separated out from the rest of the railway and sold to the private sector. Both are fairly self contained, with only limited through running by freight and passenger trains from other regions; both are predominantly commuter railways and have a clear market to serve; and for both there is a reasonable chance of financial viability. A Southern Railway in particular would be big business, larger than many foreign national railways: at present it accounts for a third of BR's passenger revenue.

36. If these two regions were to be separated off and privatised, consideration would need to be given to the obligations required of the new owners - in particular to avoid undue repercussions on road congestion as the result of changes in the fares structure - and any initial subsidy. These railways might be candidates for a subsidy to commuter services.

37. Both Southern and Anglia include a number of major and minor loss-making activities in their portfolios. They include some loss-making rural lines, such as those in Norfolk, but there are also services in the London suburbs which have a poor financial performance. It would be necessary to consider whether these would need to be protected by an obligation or could be allowed to wither under private ownership.

2.

38. A further complication is the Channel Tunnel. The Southern Railway would have to take over BR's contract with SNCF and with Eurotunnel. But a significant part of BR's commitment to Eurotunnel depends on freight traffic which would be generated outside the Southern Region. Through-running would then become more of a problem than at present.

39. The Anglian region comprises the networks out of Liverpool Street and Fenchurch Street. These are predominantly commuter services, but also include the InterCity services to Norwich.

40. The financial performance of the various parts of the railway have been examined, using such data as are available to the Department. Table 1 gives estimates of the 1991/92 performance of the component passenger subsectors of the Southern and Anglia regions.

TABLE 1

Prospective NSE Subsector Financial Performance, 1991/92
Grouped by Region

£m 1987/88 prices

	Income	Costs (CCD basis)	Profit (loss)	Income as % costs (rounded)	Type
Southern					
Kent Coast	113	103	10	110	OS
Kent Suburban	89	80	9	110	IS
Sussex	99	94	5	105	OS
South London Suburban	38	51	(13)	75	IS
Solent & Sarum	123	123	–	100	OS
Surrey & Berks Suburban	79	85	(6)	90/95	IS
Total	541	536	(5)	101	
Anglia					
Liverpool St-Cambridge	83	80	3	105	M
London-Tilbury-Southend	39	31	8	125	OS
NE London-Cambridge	37	41	(4)	90	M
Total	159	152	7	105	

OS = outer suburban. IS = inner suburban M = mixed services.

2

The figures are taken from the Board's budget data, adjusted to take account of the planned improvements over the next three years (ie they include the benefits of the higher revenue growth achieved in 1987). The figures also include estimates of full CCA depreciation charges.

41. Financial prospects and management cohesion would be further enhanced by the transfer from InterCity of the profitable Gatwick Express to the Southern and Liverpool St-Norwich services to Anglia. After these transfers, both the Southern and Anglia systems would show an overall profit.

42. The two regional passenger railways cover over 80% of the NSE sector services, including those which currently have the most noticeable difficulties in operating to satisfactory standards (the Liverpool Street and Fenchurgh Street lines and Kent Suburban).

43. The figures indicate that both Anglia and Southern are within striking distance of covering their costs under current management and, if the expectations of improvements from privatisation were fulfilled, could well be made profitable with a combination of modest real pricing of 1-2% pa, tapering subsidies and service level changes and could in the longer run be operated without subsidies if that was considered appropriate. It is unlikely that additional gains could be achieved by further subdividing the two regions. Any benefits from the small degree of competition which could be introduced would be offset by destroying the existing cohesion of the units for management and planning purposes.

<u>A Core Railway outside the South-East</u>

44. Other options need to be explored for the remainder of the system in order to separate out potentially profitable activities from heavily subsidised local passenger services. One possibility is a core railway operating freight and Intercity services over the routes shown in figure 2, bounded by London (excluding Anglia and Southern), Newcastle, Edinburgh, Liverpool, Birmingham and Bristol.(ie London Midland, Eastern and Western regions).

45. Figure 1, derived from the Serpell report shows the density of freight flows on the rail system, and also shows the main Inter City network. The freight figures are a little out of date because the concentration of flows on the central core of the railway has tended to increase with the rationalisation of the Speedlink and Freightliner networks. But they show that Freight and InterCity operate over a common network: the heaviest freight flows follow the high speed passenger routes linking the main industrial areas. (The main exceptions to this are the coal flows in the East Midlands and South Yorkshire and the Freightliner links to the ports). Although the two sectors may use separate tracks in many places, they are interdependent and share many expensive structures.

46. The commercial businesses operate mainly in the core regions of the LM, Eastern and Western. This is shown by:

TABLE 2

Approximate Regional Breakdown of Commercial Sectors' Working Expenses

Percentages

	LM + Eastern & Western	Scottish	Southern + Anglia
InterCity (excluding Gatwick & Anglia)	88	11	1
Freight	80	11	9
Parcels	74	10	16
All commercial sectors	83	11	6

47. The critical question is -can the freight and Intercity services operating inside the core network, essentially consisting of the area bounded by the principal Intercity routes as shown on Figure 2, make a satisfactory profit such that, if taken as a single railway operating unit, it might represent an attractive opportunity for private sector ownership? A privatised core railway might well be organised on a similar basis to the current BR structure ie separate marketing and planning on a sector-type model but with a common production function, certainly for infrastructure and train planning and control.

48. Such an organisation has the obvious advantage that it cuts through the issue of allocating infrastructure and other costs between two major users of common assets. The current perception of the performance of the two commercial sectors is that freight is moving forward towards profitability but on a favourable sharing of common costs whilst Inter City is struggling towards breakeven, with possibly a more onerous share. With the two systems operating under common ownership and without subsidy there is an incentive for the organisation to operate in a corporately efficient manner rather than to argue over allocation systems.

49. The organisation would need to be able to purchase the right of access to lines outside its own core of routes (ie paying for infrastructure on a marginal cost basis) but to a large degree that would go no further than the existing inter-sectoral arrangements. One assumption which is worth drawing attention to concerns contributory revenue: any estimate of InterCity revenues will be dependent in part on the rest of the network continuing to provide feeder services to the Inter City core. The significance of this is open to question.

50. The Department's estimate of the financial prospects for Freight and InterCity suggests that the existing networks could be expected to make an acceptable rate of return on the total asset base even without undertaking the sort of efficiency improvements or product rationalisation that might be expected under private sector ownership. On the basis of current plans and some modification of cost allocation systems a current cost profit of £125m representing a 4% return on total assets,including infrastructure is in prospect by 1991/92.

51. A private sector core railway would no doubt seek to withdraw from those activities in the core which are dependent on cross-subsidy for survival, such as marginal freight traffic. The environmental impact of a transfer to road would need to be considered. Our understanding of the performance of the Parcels business suggests that most of its profits are earned on its express

traffic, which is inextricably linked to the passenger business particularly the InterCity services linking the major towns. The remainder of the business is almost certainly loss-making. Most of the express parcels profits can reasonably be credited to the core railway.

One or more core railways?

52. Would it be feasible or desirable to create more than one financially viable organisation out of the core of the London Midland, Eastern and Western regions? It is likely that the degree of interworking of freight and cross-country InterCity services would mean that the London Midland and Eastern regions would need to operate as a single unit. They share common characteristics (electrified East Coast and West Coast main lines), and parallel main InterCity routes offer opportunities for diversionary routeing and service concentration (for example, sleeper services to Edinburgh via the West Coast route).

53. The need for the Western region to be part of this organisation is less clear-cut: the degree of interworking of InterCity and Freight with the LM/Eastern group is limited, and financial prospects for Western Region InterCity services look reasonable. It may therefore be possible to deal with Western separately, but further study would be needed.

Passenger services outside the core

54. Next we consider the parts of the rail system which are outside this central core but which might be formed into semi-autonomous networks and subject to tendering or franchising operations. An 'Asset Authority' (either within or outside the public sector) would be needed to plan and manage the franchises. There are four or five potential candidates:

- Scotland excluding the main East and West Coast Main lines, ie Strathclyde PTE services plus the Provincial Sector services to the north of Strathclyde which form the only large passenger network outside the InterCity core, Anglia and Southern regions;

- local services in Wales, but excluding the main line to Swansea and the Cardiff Valley services;
- The Merseyside PTE area and its immediate hinterland;
- Devon and Cornwall local services;
- The Provincial sector services in East Anglia, which could alternatively be included in an independent Anglian region.

55. Each of these service groups, with the exception of rural Wales, has the characteristic that it could be operated as a specialised management unit within a limited geographical area. The services provided are predominantly heavily loss making and likely to remain so. However the efficiency gains to be made from franchising the operation are likely to be available without the major complications of large scale interrelation between the local network and the national Inter City and Freight activity.

56. With the exception of East Anglia, these networks would all have some through running by InterCity passenger trains, but in most cases this would present no exceptional difficulties; the current arrangement in which the Inter City Sector provides services on Provincial sector lines on a 'penetrating' basis ie paying for the use of the infrastructure on a marginal cost basis, would need to be converted to a charging regime. There would be some freight traffic on these local networks but again this is within manageable proportions: indeed in some cases, like the Cornish china clay export trade, the freight movement would be wholly limited to the local network and could itself be franchised.

57. Table 3 gives an estimate of the prospective financial performance in 1991/92 of the passenger services within the five groups. They account for about 45% of the Provincial sector's costs and subsidy requirement, (PSO plus payments from the PTEs).

TABLE 3

£m 1987/88 prices	Income	Costs	Loss
Scotland	67	168	101
Wales	11	29	18
Devon & Cornwall	4	15	11
Merseyside	23	39	16
East Anglia	6	12	6

2

London commuter services.

58. The majority of NSE services outside Southern and Anglia operate on, or branch from the main InterCity lines out of Kings Cross, St Pancras, Euston and Paddington. In all 4 cases fare levels from stations in the outer South East such as Peterborough and Swindon are already the responsibility of the InterCity sector, and its trains carry a substantial proportion of longer distance commuters. For reasons of service planning and management cohesion these lines might also be owned and operated by the core commercial organisation. Paddington services are the only poor financial performer amongst these services sharing lines with InterCity, but they have the greatest potential for action on service levels and cost-reduction through service adjustments and investment in modern rolling stock; they may also have the greatest growth potential.

59. The remaining NSE services are the smaller and heavily loss-making Marylebone-Aylesbury lines, Euston-Watford local trains and the North London line (Richmond-Hampstead-Woolwich). Marylebone, at least, is a candidate for separate operation under franchise.

2.

Provincial Inter-urban.

60. A proportion, but by no means the whole of the longer distance Provincial sector inter-urban (limited-stop) services in England and Wales would also fit into an extended InterCity operation. Candidates might include the core of the Northern Transpennine subsector (Liverpool-Manchester-Leeds York), and infill services on Intercity main lines. Information is not available to judge the financial prospects of individual parts of the 'Sprinter Express' network.

City-region local networks

61. Inside the core illustrated in figure 2 are a number of city-region networks which might be candidates for independent operation. Most of these would be based upon the existing PTE areas, though they would need to be expanded to include services operating across PTE boundaries into the adjacent Shire counties. Table 4 shows the prospective financial performance of the city-regional networks. Like the peripheral networks discussed earlier these are all heavily loss-making.

TABLE 4

£m 87/88 prices

	Revenue	Current Costs	Loss
Greater Manchester, North East Lancashire & North Cheshire	35	77	42
West Yorkshire	12	30	18
South Yorkshire & Humberside	13	34	21
West Midlands	16	28	12
Cardiff Valleys	5	15	10

62. Independent city region operators would manage vehicle fleets, maintenance depots and local stations (main stations would be shared with the core commercial railway), and directly employ train crew, train maintenance and station staff. The extent to which they would have exclusive use of lines will vary, depending on how many local services operate on InterCity routes or other lines which the core railway would own for freight purposes.

Remaining local services in and around the core.

63. These account for for about 15% of the costs, and subsidy of the Provincial sector, and cover around 1000 route miles. They are a mixture of

- long distance cross-country routes; for example the line from Newport to Chester and Crewe along the England/Wales border;

- shorter cross-country lines with the core eg Oxford to Hereford and Stoke to Derby;

- local services in urban areas but too small to class as local networks eg in Tyne-Wear, Cleveland and Avon counties;

- individual branch lines such as Newcastle-Carlisle and Hull-Scarborough.

64. Without exception these services are heavy lossmakers. A number could potentially be operated separately as small self-contained local railways; in most cases these routes are within a single 1, or 2 adjacent shire counties.

2.

CONFIDENTIAL

CONFIDENTIAL

Summary

65. Table 5 summarises the financial prospects of the BR activities discussed so far, together with the remaining groups of London commuter and Provincial sector passenger services operating within and around the core network.

Further Work on British Rail

66. The above analysis has been undertaken using the (limited) data available to the Department. To form a full appraisal of the various options, more detailed information is required on the costs and revenue of different businesses around the country. This would require the co-operation of the British Railways Board. However we have sufficient confidence in our data to recommend further consideration of the following packages, which might be developed step-by-step:-

a. the privatisation as two separate businesses of the Southern and Anglia Railways with appropriate regulation (and possibly some element of subsidy);

b. the privatisation of the main Inter-City and Freight Services as a single railway service group;

c. a combination of concessions and franchising for the remaining services, retaining the ownership of the track within a holding company (probably under public ownership). Further consideration will be needed for the subsidy regime (including the extent of local responsibility).

2

TABLE 5

Financial Prospects 1991/92 - Summary

£m 1987/88 prices (rounded)

Passenger Services outside Core	Income	Current Costs	CC Profit (Loss)
1. London & South East commuter regions			
- Southern (including Gatwick)	560	545	15
- Anglia (including London-Norwich)	185	175	10
2. Regional & subregional local Passenger outside core: Scotland, rural Wales, Devon & Cornwall, East Anglia,	110	260	(150
Activities within core			
1. Core commercial: InterCity, Freight, Freightliner, Parcels	1485	1360	125
2. Other Passenger Activities:			
a) LSE commuter excluding Anglia & Southern			
- on InterCity main lines	110	125	(15)
- Other	20	30	(10)
b) England - Provincial Inter-urban	45	85	(40)
c) Provincial City-region local networks	80	185	(105)
d) Other local services in and around the core	20	50	(30)

2.

PART 4: OPTIONS FOR THE LONDON UNDERGROUND

67. As with BR, the London Underground system has improved its financial performance in recent years but inefficiencies and restrictive practices remain. Passengers current perception is that quality has deteriorated though in part this is the penalty of the Underground's success in attracting more passengers. The objective of privatisation should be to create changes in management attitudes and performance to achieve greater efficiency and a more innovative approach. The fire of Kings Cross has created a complicating issue (the full force of which is as yet unclear).

Considerations of Structure

68. As a general principle, the efficiency gains from any privatisation would increase if competition could be introduced. One approach would be to split the system into an infrastructure company and one or more operating companies. The latter would own or lease rolling stock which would be run on trackrented from the former. However, there are commercial difficulties in such a system. This is particularly so in the case of the Underground, for two reasons. The infrastructure company is in an exceptional position as it would not be economic for anybody else to build new lines to compete directly with existing ones; and the rigidity of the fixed track system, the tight control of running times and speeds, the lack of alternative depot facilities and the dedication of the vehicles to particular lines all make it difficult for such a system to envisage different companies competing on a single stretch of track.

69. An alternative method of introducing competition is to split the system into its different lines. It is possible to consider a finer division than for BR, because the lines are in the main independent of each other. But the opportunity for competition between lines is limited by the fact that over most of the network the lines are not close together. The disadvantages of splitting could be large.

i. Particularly in the central areas there are many stations and other facilities which are shared by different lines and the separation of the management and cost of such elements would be difficult.

ii. For passengers there is, overall, a high deqee of integration in use of the system: an estimated 54% of journeys involve using more than one line. The concept of Travelcards encourages passengers to think of the Underground as a system. There is a high level of passenger interchange between different lines and separation would require either physical control on movement between platforms, for which there is not generally space, or complex procedures for revenue allocation.

iii. There are some genuine efficiency gains to the co-ordination of investment and planning over the whole network and from the ability to interchange rolling stock between different lines, which would be lost. While rolling stock is not normally interworked on a regular basis there is some ability to switch trains as shown by the cascading effect of the new trains currently being purchased.

These considerations suggest that the Underground would be better treated as a single system, like Southern or Anglia on BR, and not sold in smaller parts.

<u>**Financial Viability**</u>

70. In order to test the possibility of privatisation , the financial viability of the Underground has been examined using assumptions about staged fare increases and unit cost trends, and ignoring for this purpose the possible case for subsidy. The fares increases assumed are higher than the current IFR projections; in cash terms they are 9½% in 1988, 8½% in 1989 and so on tapering down to 5½% in 1992 and matching inflation thereafter. The unit cost reductions, in real terms, of 4½%, 4% and 3% in 1988/89, 1989/90 and 1990/91 and constant thereafter, are perhaps conservative, but

recognise the increasing difficulty in securing further reductions after six years of cutting costs. The results of these projections are illustrated in table 6. The input assumptions are obviously the key to this forecast of profitability and it is possible to obtain the same result with different mixes of fares increase and unit cost reduction. A programme of price increases on a tapered basis (from the 9½% agreed for January 1988 by 1% per annum to 5½% in January 1992) will be sufficient to secure the target level of trading performance without subsidy, even if it proved impossible beyond 1989/90 to cut costs further.

Table 6

Projected Financial performance of London Underground

£m outturn prices

	1987/8	1990/91	1993/4	1996/7
REVENUE	416	555	643	724
COSTS	469	498	546	614
PROFIT/(LOSS)	(53)	57	97	110
Cash surplus or deficit after funding planned investment	(112)	26	42	48

2.

71. The projections suggest that the Underground could be profitable by about 1990 and that the system could remain profitable throughout the 1990's and generate sufficient cash to fund its current investment programme. On that basis it would be possible to float LUL with a record of trading profitability by about 1993. It would be possible to bring forward this date if subsidies (either on a temporary, tapered basis or a permanent subsidy calculated to buy road congestion relief) were to be paid.

72. The projections suggest that LUL would be able to show profit and positive cash flow whilst maintaining its planned levels of investment. This investment includes some betterment (eg station modernisation), justified on social grounds but which would not necessarily be supported by a commercial operator as essential to the maintenance of the network. On the other hand existing projections do not take into account investment, possibly on a substantial scale, which may be necessary over the next decade or so to deal with the requirements of safety (following Kings Cross) and the current overcrowding on the system.

73. New lines or extensions on the Underground are very costly and take a long time to bring to fruition. It would be for further examination whether the financing of desirable additions to the network would present problems for a privatised Underground company. The Government might still find it necessary to intervene in some way to facilitate such schemes.

74. Property development at station sites has the potential to add considerably to the value of the business; but it cannot at present be quantified. It may not be possible to secure that value on flotation unless the development opportunities can be identified and included in the prospectus with the backing of firm development plans. An alternative arrangement which attempts to retain future development proceeds separately from the main Underground proceeds appears feasible but would add complexity.

75. The assumptions and projections underlying this appraisal would need to be refined and tested with LRT/LUL to ensure that they are both credible and also convey the right signals for developing a more commercial future for the business. In particular more work is needed to examine the long term investment programme and the related accounting policies; and to examine further the opportunities and mechanisms for exploiting property value.

76. It also has to be borne in mind that management systems and information in the Underground are not at present satisfactory, and a good deal more needs to be done before they could be convincing to City analysts.

Conclusions on the London Underground

77. The existing financial projections suggest it would be feasible to privatise the Underground by 1993 given a programme of steady but not large real fare increases over the next five years. The main risk to the forecast is that recent large growth in traffic is reversed, though this does seem very likely. The complicating factors are the aftermath of the Kings Cross Fire and the possible need for major new investment to deal with overcrowding.

78. Further consideration is needed in particular of:

a. the form of regulation

b. the form of the service obligations

c. the level and nature of any subsidy.

79. Thereafter, the subsequent steps would be:

a. ensure that the Underground has a management which can get the business ready;

b. get an opinion from a merchant bank on the financial projections and the privatisation option;

c. obtain the necessary legislation.

2

FIGURE 1

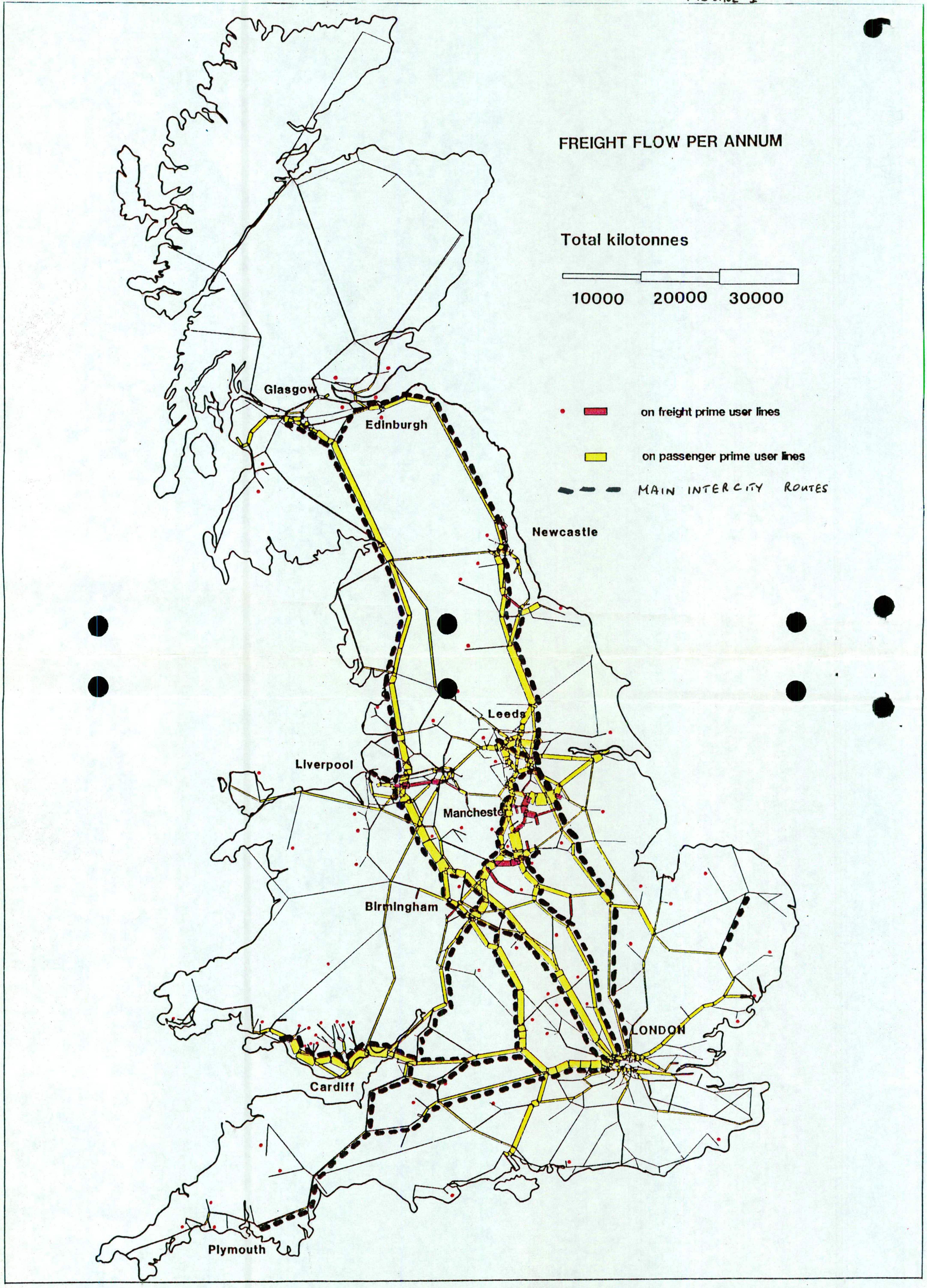
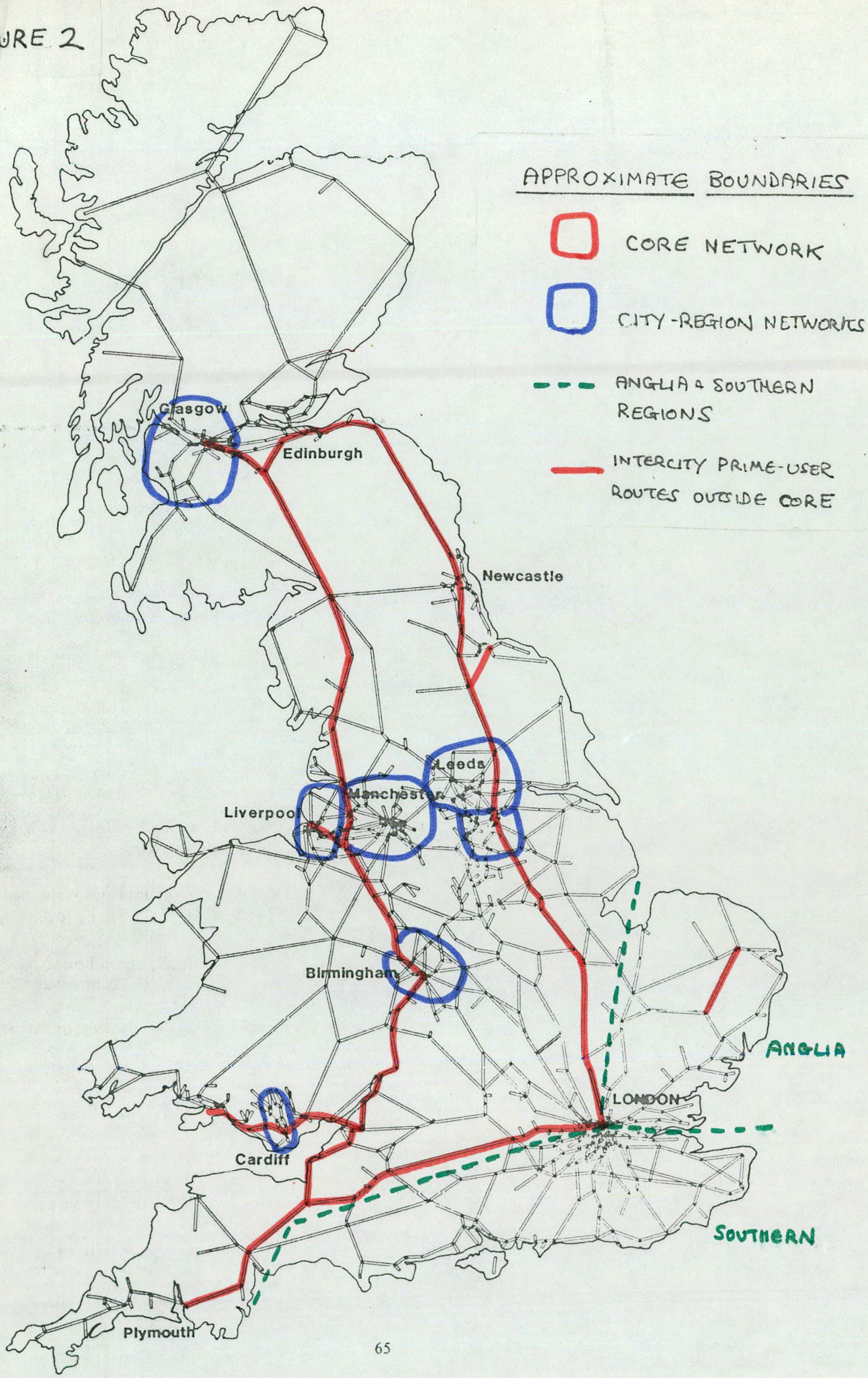

FREIGHT FLOW PER ANNUM
Total kilotonnes
10000
20000
30000
on freight prime user lines
on passenger prime user lines
MAIN INTERCITY ROUTES
Glasgow
Edinburgh
Newcastle
Leeds
Liverpool
Manchester
Birmingham
LONDON
Cardiff
Plymouth

FIGURE 2


APPROXIMATE BOUNDARIES
CORE NETWORK
CITY-REGION NETWORKS
ANGLIA & SOUTHERN REGIONS
INTERCITY PRIME-USER ROUTES OUTSIDE CORE
Glasgow
Edinburgh
Newcastle
Leeds
Manchester
Liverpool
Birmingham
Cardiff
LONDON
Plymouth
ANGLIA
SOUTHERN

SA11.013.SS

EF 9/6

The disposal of TF as a single entity is not as anti-competitive as it may appear. The option of separate sales of multiple sites at about 30 stations is being pursued (para 7 below); at the main stations TF is already exposed to vigorous competition; and where there is a monopoly we shall press DTp to ensure that it is contestable – e.g. BR is encouraged to give leases to new entrants who apply.

VG 3/6.

FROM: P M RUTNAM
DATE: 3 June 1988

1. ~~MR GUY~~
2. **FINANCIAL SECRETARY**

cc Chancellor
Chief Secretary
Mr Anson
Mr Monck
Mr Moore
Mr A Williams
Mr Guy
Mr Bent
Mr T Davies

Grateful for urgent views of Frank Cull on this.

Response

BRITISH RAIL: PRIVATISATION OF TRAVELLERS FARE

This is to inform you of the background to British Rail's decision to dispose of its station catering subsidiary, Travellers Fare (TF). BR announced today that it plans to sell TF as a single entity by private treaty sale. On balance we are content with this decision, but you will wish to be aware of the considerations underlying this judgement.

Background

2. TF currently runs catering operations at about 135 BR stations. It is a dominant force in the station catering market, with outlets ranging from kiosks selling sandwiches, confectionery etc to high turnover fast food outlets at major termini. It does not provide catering on board trains (this is run separately by the main BR sectors, under competitive tendering). However, it does operate at stations under various brand names apart from TF, including Casey Jones (selling hamburgers) and Uppercrust (cakes and pastries). The company's total turnover last year was about £70m with net profits of £5.5m. BR and its advisers estimate that disposal could raise between £20-35m, depending on the particular form of disposal and on the strength of interest in the sale.

Options for disposal

3. BR's decision, which has been endorsed by DTp, is for the sale of the company as a single entity, by private treaty

to the highest competitive bidder. On the whole, this is acceptable. However, we did examine other options for the form of the disposal with DTp, and the form chosen may have significant implications for competition in the station catering market. You will, therefore, wish to be aware of the factors underlying our acceptance of BR's choice of this option for disposal, as against other possibilities.

4. The key consideration is competition. The market in station catering is fragmented and not fully competitive. At the busiest stations, such as Euston and Victoria, catering is now highly competitive, with TF and private sector operators competing from a number of outlets. Stations such as these account for about 40% of TF's turnover, but at its other outlets TF faces much less competition. At 60 stations (a further 40% of TF's turnover) TF competes only with confectioners etc retailing snacks, and at 65 stations (but representing only 19% of TF's turnover) TF operates without any competition at the station. Even in these stations TF cannot, of course, act as a monopoly as it usually has to compete with vendors just outside the station, and with catering on board trains. However, it is clear that the market could be more competitive than it is at present.

5. If TF were not sold as a whole, but broken up, it might have been possible to stimulate more competition in station catering. However, the practical difficulties of break-up would have been very serious. TF is structured as a single company, not as a group of companies trading under different brand names. A break-up into smaller parts would therefore have led to extra costs and reduced profits before sale. There would also have been a problem of staff morale during the restructuring and sale period, which would be lengthy (BR say it would take more than a year). The extra costs involved would also probably have more than offset any higher proceeds from the sale of TF as more than one company, particularly as the company may attract a premium if sold as a whole.

6. It was also not obvious how the company could be structured so as to maximise competition, if it were sold in more than one part. Competition in station catering works on a station by station level, and so sale by region (TF has a regional structure) would serve no purpose. None of the individual TF brands is large enough to form a coherent business that would compete effectively with the rest of TF if sold separately (Casey Jones, the largest of the brands, operates mainly at London termini - already a competitive market). It might just have been possible to increase competition by creating two groups of outlets from the whole range of TF outlets. But this would have been the most difficult, costly and lengthy form of restructuring. It would also have been strongly opposed by BR, which wants to dispose of the business as soon as possible.

7. We pressed DTp on yet other ways to enhance competition in this market through the disposal of TF. One possibility is excluding from a sale of the company as a whole multiple sites which TF is operating at one station. Leases on one or more of these sites might then be sold separately, leading to an increase in competition at about 30 stations. We are not clear, however, how exclusion of these sites might affect total proceeds, and the point is still being pursued.

Conclusion

8. On balance we are satisfied that disposal as a whole will be the swiftest way in which BR can end its involvement in catering at stations, and is likely to maximise the proceeds from the sale. While the market is not as competitive as we would like, the entry of new operators will help increase competition. Restructuring the business to increase competition through the sale would have led to a long delay before disposal and have been unpopular with BR and TF. It would also not have been likely to increase total proceeds. We are therefore content with the BR's decision to dispose of TF as one entity.

P M Rutnam

P M RUTNAM

MC5.79

FROM: MARK CALL

DATE: 7 JUNE 1988

CHANCELLOR

cc Chief Secretary
Financial Secretary

PST – I v. much agree that [illegible] Mr? [illegible] still occur. If not, BR [illegible] [illegible] A single trade sale might be OK for all stations & premises [illegible] terminals [illegible] stations [illegible] all progress [illegible] restaurants [illegible] single chain [illegible] caterers [illegible]

BRITISH RAIL: PRIVATISATION OF TRAVELLERS' FARE

You asked for my views on the proposal to sell Travellers' Fare as a single entity. I feel it is a pity that an opportunity has been missed to achieve greater diversity and competition in rail catering. However, given a few safeguards and progress on the point made in paragraph 7 of Mr Rutnam's minute, it is not an issue over which one would go to the stake.

Para 6 of Mark Call's note is also important.

2. Because of the low economies of scale in this kind of activity, small single site enterprises can be viable. Splitting TF could thus have introduced greater diversity, choice, as well as competition. Victoria Station concourse bears witness to the lost opportunity. The still lamentable state of many motorway service stations illustrates what threatens if little competition is experienced. Mr Rutnam's description of TF as the "dominant force" in station catering sets alarm bells ringing.

3. The competitive considerations might have looked at not only the impact of such a dominant competitor, but also the question of new entrants to the market, or expansion by existing non-TF companies. For example, single outlets might have been of interest to non-rail restaurant operators in station towns. Again splitting would have allowed existing successful non-TF station caterers to expand by buying TF outlets. In a trade sale they will not get a toehold.

4. In paragraph 6, Mr Rutnam argues that "competition in station catering works on a station by station level so sale by region would serve no purpose". For sale by region there may be something in that. But sale by outlet would have had some merit. A single outlet business is going to try hard because its survival depends on the success of that outlet. And of course one could give them an operator's licence, renewable at intervals. Rather than have BR attempt to judge performance these could simply be auctioned. This approach would be more appropriate for the large number of stations where TF experiences virtually no competition. The rest could be a trade sale.

5. The size of TF is such that any net loss of proceeds would probably be worth it for the potential gains in competition and diversity. I'm not, however, convinced that breaking up TF would add much to cost - most potential purchasers of parts of TF probably run tight operations with a low cost base. They would be unlikely to replicate TF's overhead structure.

6. Finally, if a trade sale goes ahead we should pursue the point made in paragraph 7; and ensure that train-based catering is run by competitors to a privatised TF.

Mc

MARK CALL

FROM: W GUY

DATE: 3 August 1988

1. MRS BROWN 4/8 MEB

2. CHANCELLOR

cc CST
FST
EST
Sir P Middleton
Mr Anson
Mr Monck
Mrs Case
Mr Moore
Mr Hawtin
Mr Houston
Mr Rutnam

Ch/
Content to write as proposed?
AB 5/8

PRIVATISATION OF BRITISH RAIL

Mr Channon minuted the Prime Minister on 29 July reporting the outcome of his further consideration since February.

2. His proposed timetable for action is at his Annex F. He is proposing a speech to the Party Conference in October; a White Paper next spring; restructuring of BR in April 1990 and privatisation in 1993 or 1994.

3. Further work is tending to confirm the preference for restructuring on the basis of a mix of the present business sectors and new regional railways. The problem of what to do with the hopelessly loss-making services of the Provincial Sector remains but it is anticipated that over the next five years the unsupported sectors and Network South East should move to a positive return on assets through a combination of gradual real price increases; cost reductions; and volume growth.

Guy
1. BROWN
2. CHEX
3/8

__Fares and Closures__

4. Mr Channon shies away from your earlier suggestion that the

prospect of privatisation gives a new impetus to decisions on closures and fares. Closures he regards as all too difficult and on fares, particularly increases to move NSE out of loss early, he talks about road congestion. As to the Provincial Sector, Mr Channon's minute hints at a solution to be found in devolving responsibilities and resources to local authorities. We are suspicious of this. He also hints that for some parts of the Sector, such as Scotland and Wales, the problems may be intractable. DTp officials are beginning to think seriously of not privatising ScotRail, and we can sympathise with their problems.

5. It makes no sense to parcel out the rump of loss-making services as burdens on the commercial businesses which can be extracted from BR. But if the rump is privatised as companies which are dependent for a significant (and probably the major) portion of their income on variable subsidies, it will be difficult to capture the benefits of privatisation. The new alert, revenue maximising owners will focus their attention on maximising their subsidy. There is no reason for the upshot to be any better performance on costs or services than BR delivers at present, and the situation could be more difficult to defend. It would not be much easier, and it could be harder, to use the subsidy mechanisms to eliminate services than it is at present.

6. At present Mr Channon reckons it politically impossible to eliminate services in Scotland and Wales. If privatisation would therefore lead to private companies propped up entirely by subsidy, constantly battling to achieve oversubsidies against a hedge of public sector regulations designed to reduce subsidies whilst maintaining services, the result would not be satisfactory.

7. We are not ready to throw in the towel, but we have no brainwave solutions to offer. The Policy Unit are also struggling: they believe it right to identify clearly those parts of the service where political and social considerations govern decisions about future provision; and to face up to making those decisions. They are musing with ideas about companies which are bound by Articles of Association to be subsidy-minimisers, or

delivering the subsidy direct to customers in the form of travel vouchers. Neither idea looks very hopeful.

8. But we are clear, and so we believe are the Policy Unit, that those other bits of the railways which have potential for running profitably should be made profitable as soon as possible; and those bits which we shall not wish to see subsidised after privatisation should be eliminated as soon as possible. This does require a new impetus to thinking about fares and closures, and it is disappointing that Mr Channon seems to be drawing back from this. Hard decisions on prices and unprofitable activity will be necessary sooner or later: sooner would get them out of the way before they can jeopardise the presentation of policies on privatisation. But 'sooner' means very soon indeed: privatisation in 1993 only gives about 3 years to get ready in, and in that period detailed privatisation proposals will emerge and be judged against the implications for fares and services.

9. For NSE fares in particular we believe there is much to be said for a 'big bang' next January to get the Sector out of loss. (The RPI consequences would need to be considered: for every percentage point real increase in rail fares generally the RPI would increase by 0.007 per cent. The kind of bang necessary to bring NSE out of loss next January would thus have a significant impact. It could amount to a 10-15 per cent real increase instead of the one and a half per cent real increase already built into the forecast. NSE journeys account for a significant proportion of total rail journeys, but we are not sure exactly how much. NSE income is about a third of total BR and LUL income, which accounts for almost all rail services. The effect of a further 10 percentage points on NSE fares could thus be to add something like 0.02 per cent to the RPI).

10. There appears to be a dilemma between stepping up the momentum of public debate on privatisation and stepping up the pace of rationalisation of BR, if the two issues are not to become linked. Mr Channon wants to go strongly for privatisation and he believes therefore that there should be no drama about rationalisation. We believe that there is a way through if he

alters his presentation slightly so as to lead on the need for continuing the present trend to greater efficiency and profitability (including rationalisation) and to say that success with this will make privatisation possible.

Restructuring

11. There needs to be faster progress towards restructuring, so that Sir Robert Reid can be told to get on with it before the end of his term looms. Otherwise too much time will be wasted before a successor is put in place. We believe that the Department is right to favour breakup into a mix of business sectors and regions, and that Mr Channon should give a steer in this direction as soon as possible and give Sir Robert Reid the objective of preparing proposals for setting up a new structure under BR management. This again could be presented as something which is necessary and desirable regardless of privatisation.

Handling

12. The Prime Minister will not see Mr Channon's minute for about a fortnight. It would be helpful if you could also minute during this period. Mr Channon has pointedly not copied his minute to Mr Rifkind or Mr Walker, so there is an opportunity to set the tone now for subsequent discussions in which they will certainly fight against anything implying closures in their territories.

13. The best tactic seems to be to establish with the Prime Minister now that whatever happens to the 'Celtic fringe' railways, there _must_ be early action to bring the potentially profitable railways into profit, and that DTp should not shy away from the decisions necessary to achieve this.

14. There should also be faster action towards restructuring, so as not to waste the remainder of the current Chairman's term.

15. A draft minute to the Prime Minister is attached.

W GUY

Continue to write as drafted, as slightly amended. But work needs to be done urgently on the precise elasticity of rail fares, taking account of the effects on the need for road expenditure. Some fare increases may well raise less additional revenue than the consequential increased road congestion cost/need for extra spend on roads. It may turn out in some cases, if elasticity ~~[illegible]~~ enough, that fare reductions wd be economic, tho' I doubt it. But unless & until such work has been done HMT calls for fare reductions will fail to carry conviction.

M

DRAFT MINUTE TO PRIME MINISTER

PRIVATISATION OF BRITISH RAIL

Paul Channon's minute of 29 July proposes a way forward beginning with a speech to Conference in October.

2. I entirely agree with Paul about the benefits which privatisation of our railways ~~should~~ could bring, both to customers and the taxpayer. We now need to put every effort into this task. This will require some hard decisions.

3. I believe that action is needed urgently on a number of fronts to prepare the railways for privatisation in or next term:

(i) in those areas where fare increases can be justified as part of the initiative to make rail services more commercial, we should bring in the increases required as soon as possible and not rely on a gradualist approach. The sooner that the railway managers find themselves in a commercial environment, and the sooner a track record of profitability can be established, the better. And the sooner that the customers get used to paying the right rate for the service they receive, the better ~~also~~ too. This is - and should be seen to be - a continuation of our policy of improving the efficiency and profitability of all our nationalised industries. It is not just "setting up" for privatisation.

Increases are needed particularly in London's rail systems (especially Network South East) with effect from next January.

(ii) new investment in railways should be on a basis which will provide profitable services. We do not want to entrench the concept of operating losses. There may always be scope for capital grants to assist construction, but we have more than enough rail services with operating losses already.

(iii) where new railway systems are proposed we should encourage the private sector to think not abut lending money to the public utilities to build them, or taking equity stakes in the returns which the utilities will make, but about building and <u>operating</u> lines in the private sector. We should be prepared to take on the ~~entrenched interests of the~~ rail unions ~~on~~ over this. We shall have to do so sooner or later if there is to be a successful privatisation of the existing railways;

(iv) we must face up to difficult decisions about the future of uncommercial services. I fear that for some of these the benefits to the local population are grossly overstated. Sooner or later <u>we</u> will need to tell BR or its successors what to do with these services and it will not be easy. Those services which we feel we shall not wish to support forever, we should think very hard about withdrawing <u>now</u>. Where we do decide to retain uncommercial services, we must get on straightaway with devising the right form of subsidy. ~~This will not be easy:~~ we need a basis which maintains commercial incentives ~~on~~ for the operator, and which does not ~~mean~~ involve imposing excessive regulation on the system as a whole. Careful thought wil need to be given to this.

(v) we must not waste the remainder of Bob Reid's term. We cannot afford to if we want to be ready to privatise in 1992-93. We should therefore give a steer as soon as possible towards restructuring BR and we should set Bob Reid to work on it before the end of this year. We may have to give him new objectives before his current ones expire: I do not see this as an insuperable difficulty. The existing objectives have been overtaken by growth in passenger revenues anyway and we need to stop this from bolstering operating inefficiencies.

4. On the question of restructuring I see no harm in spelling out now that a national track authority is not attractive; that the existing business sectors would need some restructuring; and that switching to entirely regional railways would not serve the needs of long distance travel on 'core' routes. Given the amount of work which has already been done I would not think it premature to give the public debate an early steer in the direction of our preferred option, a mix of regions and business sectors. We do not want momentum to be lost ~~whilst~~ while the White Paper ~~on~~ setting out the details is prepared. But one point on which we may be in danger of getting ahead of ourselves is ~~devolution of~~ the proposal to devolve the responsibilities and resources for loss-making local services to local government. It

has some attractions but there may be pitfalls which need to be more closely explored before we announce that we are going that way.

5. I would therefore suggest a slightly different emphasis in Paul's speech to the Conference, stressing the continuation of our present policies and saying that it is the success of these which is opening up the ~~this will open up~~ prospects ~~for~~ privatisation. ~~in due course~~. We should avoid giving the impression that decisions about fares and structure need to be taken only because we have now decided to privatise. ~~We should instead stress that~~ Action in these areas is essential in any case, ~~as I believe it is to be.~~

6. A copy of this goes to Paul Channon.

N L

pe.sh.docs.pr.31.8

PMP

Ch/ I understand FST has (reluctantly) written as drafted, giving in to DTp

MPW. 5/9

FROM: P M RUTNAM

DATE: 1 September 1988

1. MR MOORE (discussed in draft)
2. FINANCIAL SECRETARY

cc: Chancellor
Chief Secretary
Sir P Middleton
Mr Anson
Mr Monck
Mr Guy
Mr Cropper
Mr Tyrie
Mr Call

BRITISH RAIL: PRIVATISATION OF TRAVELLERS FARE

Mr Portillo's letter to the Economic Secretary of 26 August, in reply to the latter's of 9 August, is to inform you that he intends to tell BR very shortly that they can go ahead with the sale of TF as one entity, without excluding from the sale any of the individual outlets operated by the company. This amounts to a rejection of Treasury pressure for a disposal structured so as to increase competition in station catering, rather than simply to maximise proceeds. Mr Portillo does, however, reveal several new developments in the affairs of TF since your exchange with Mr Channon in July, which fortuitously tend to justify the original attitude assumed by DTp before they had this new information. In the light of this new information we recommend that you now accept the disposal of TF as a single entity. If you feel nonetheless that it is necessary to intervene to stop DTp telling BR to go ahead, it would be best if this were done as quickly as possible, by close today at the latest.

Background

2. You will recall that when you wrote to Mr Channon on 18 July you asked him to re-examine the case for excluding from the main sale of TF some or all of its 'multiple outlets' (ie, where TF has more than one outlet on the same station). At those stations where TF has more than one outlet and there is no other competition, you suggested that selected sites should be put up

for separate tender to introduce a new element of competition and reduce TF's market dominance. Mr Channon replied (4 August), rejecting the claim that competition would be increased by separate tendering, other than at the margin, and arguing that the additional costs/delays involved would lower proceeds and damage the sale of the rest of TF.

3. In your absence on leave, the EST replied to Mr Channon (9 August) saying that he did not take the same view of the competition benefits. Discussions have continued since at official level, and we have pressed DTp to look at several illustrative options for the effects of break-up and separate tendering on competition proceeds. It is in the light of this further work that Mr Portillo has written.

New developments

4. Mr Portillo takes the same view of the competition/proceeds argument as Mr Channon; this adds nothing to the argument. But he also reveals some important new developments that affect the case for separate tendering. In particular, he says:

i. BR has now completed, with its property advisers, a review of the rents at TF outlets to bring them up to commercial levels. This has had a severe impact on TF's profitability: profits of £7.5 million (on turnover of £74 million) last year, are expected to change into a loss of £1 million this year.

ii. According to BR's advisers, Hill Samuel, and DTp's (Deloittes), the business will be difficult to sell unless BR provides some form of transitional relief to cover these losses for the first couple of years after the sale. This is expected to cost BR about £2.5 million. The gross proceeds, which had been forecast at £20 - 35 million in the Spring, are expected to suffer with the lower level of profitability and lower quality of the earnings. BR now expects no more than £10 million gross from the sale as a whole, or £7.5 million net of the relief.

iii. Many more stations are now expected to be redeveloped by BR over the next few years, including all the principal termini with multiple outlets.

5. For reasons discussed below, in looking at the effects of separate tendering on competition and proceeds DTp/BR have left out of their calculations the sites at stations up for redevelopment. If a selection of the remaining multiple outlets were taken out of the main sale, TF's losses would increase by £0.5 - £1.0 million, depending on the particular sites and number chosen. The figures for proceeds and transitional relief (in (i) and (ii) above) would change accordingly. Assuming a <u>high</u> level of separate tendering, Hill Samuel estimate the net proceeds from the sale TF might drop by £3.25 million. The <u>relative</u> effect on proceeds of the separate tendering for which we have been pressing would, therefore, be considerable.

6. DTp admit that the effects on competition are, of course, not so easy to pin down. But point (iii) above is important here. The concern you voiced in July was particularly in respect of the largest stations with multiple TF outlets but no private competition (eg, Charing Cross, Kings Cross, Liverpool Street, Newcastle). All these stations are now planned for redevelopment over the next few years. Past redevelopments, at eg Euston, Victoria, Waterloo, have allowed BR to build special shopping malls including a much wider range of private caterers. Much the same is planned for these future redevelopments. The purchaser of TF will not be sold leases on the sites at these stations, but a tenancy which will terminate on redevelopment. He will also be given a right of first refusal on <u>some</u> of the sites that will exist <u>after</u> redevelopment, but Mr Portillo assures you, this will not lead to any exclusivity in catering at these stations after redevelopment. BR's policy here, as in past redevelopments, will be specifically to encourage competition.

Assessment

7. The increase in the number of stations to be redeveloped makes the case for delaying the sale to tender separately sites at the other stations weaker if one accepts Mr Portillo's argument about redevelopment. It would, however, be possible to argue for separate tendering at the redevelopments stations <u>also</u> on the grounds:

a. that redevelopment may not happen for several years; and

b. there would be less concern about rights of first refusal to these sites after redevelopment if they had already been let to various operators.

DTp/Hill Samuel say, however, that separate tendering of these outlets would kill the rest of the sale, ie the <u>whole</u> of TF would have to be sold by tendering its sites individually. (This was the approach to disposing of the business that BR used until late last year, when it stopped encouraged by the prospect of selling it more quickly, and for a premium, if as a whole.)

8. It would be easier to insist on separate tendering of the other, non-redevelopment stations. But there is some force in DTp's argument that the competition benefits here would be limited. The stations are smaller (eg Colchester, Plymouth, Cambridge and Bristol), and turnover in catering is smaller. At some of the stations, the outlets that would be tendered separately are a long way apart and/or sell rather different, not necessarily competing products (eg bars and coffee shops).

Recommendation

9. On balance we recommend against pressing DTp again for separate tendering of outlets at the non-redevelopment stations. If separate tendering went ahead, there <u>would</u> be competition advantages, but they would probably be patchy, and have to be offset against the very significantly lower proceeds for the rest

of the business. On the other hand, BR should receive some consideration for the profitable outlets tendered separately (though DTp/Hill Samuel have not accepted this point). There would also be additional redundancy costs with separate tendering and some delay (though no doubt exaggerated by DTp).

10. The competition advantages are uncertain and, for what they are, probably not worth the probably serious damage to the prospects for an early and successful disposal of TF. If we continued to press, there would also be the rancour with DTp that would ensue. The case for separate tendering at the non-redevelopment stations does exist, however, and could be made to DTp again if you wish.

11. If you are content to allow Mr Portillo to tell BR to go ahead without any separate tendering, a draft reply is attached.

P M Rutnam

P M RUTNAM

DRAFT LETTER TO MR PORTILLO

BRITISH RAIL: PRIVATISATION OF TRAVELLERS FARE

You wrote to Peter Lilley on 26 August further to the earlier correspondence between myself and Paul Channon.

I note the new developments regarding TF's profitability. I am sorry that the significance of the rent review carried out by BR was not anticipated when your officials discussed with mine the possibilities for the future of the business in June and July. I note also that BR now plans to redevelop many more stations than seemed to be the case only two months ago: I am sorry also that this was not foreseen in earlier discussions.

In the light of the new profitability estimates I agree that it would not be sensible to tender separately the outlets which we have been discussing (that is, outlets at stations where TF has more than one site and where there is no other on-station competition).

I am content with the treatment that you propose of the stations that are to be redeveloped, providing there is an assurance that there will be vigorous competition amongst different operators at these stations after redevelopment. This is a point to which I attach particular importance, and I think that the Board's letting policy on redevelopment stations, as elsewhere, will need to be watched to ensure that it is indeed making every effort to promote competition. Perhaps you could keep me informed of progress in this area.

I should also, of course, like to be given an opportunity to comment on the proposed terms of disposal of TF, as and when bids have been received.

NORMAN LAMONT

pe.sh.djlm.min.16.9.2

CONFIDENTIAL

PPs pt (I minuted in August perhaps → Mr Guy)

FROM: D J L MOORE

DATE: 16 SEPTEMBER 1988

CHANCELLOR

Thanks. [illegible]

cc: Chief Secretary
Financial Secretary
Sir P Middleton
Mr Anson
Mr Byatt
Mr Monck
Mr Philips
Mrs Case
Mr Spackman
Mr Turnbull
Mr Houston
Mr Revolta
Mr Guy
Mr Morgan
Mr Nicol
Mr Williams
Mr Call

FARE ELASTICITIES ON LONDON UNDERGROUND AND NETWORK SOUTHEAST

We have argued, both in the context of preparing for the possible privatisaiton of British Rail and in advising the Chief Secretary on the Rail IFR bids, that there is a case for real increases in fares, particularly in the Network SouthEast commuter region.

2. You asked for some work on the price elasticity of rail fares, and the possible consequences for road congestion and costs.

3. I attach a paper by Mr Morgan which he has prepared in consultation with colleagues here and using information from Transport. His conclusions are in paragraph 11 at the end of his paper. In brief, they are that even substantial rail fare increases would have relatively minor effects on London road use and congestion at peak times.

MORGAN 16/9

4. I hope that the paper will be useful background material for the end September discussion on Rail privatisation and for the Chief Secretary's bilateral with Mr Channon next week. We have to recognise that Mr Channon might argue that whatever the economic case there could be presentational difficulties in introducing large real fare increases when we are not meeting well substantiated demand for additional road building. But we continue to believe there is a sound case for fare increases which will lead to a faster elimination of rail subsidy in the South East.

D J L MOORE

FARE ELASTICITIES ON LONDON UNDERGROUND AND NETWORK SOUTH EAST

BACKGROUND

1. This note sets out current information available on the effects of real fare increases on peak-time passenger demand for British Rail Network South East (NSE) and the London Underground. The purpose is to examine the potential extent of undesirable increases in road congestion which could follow from rail fare increases.

2. The predominance of rail as the major mode of transport for peak time commuters into London is shown in the following table.

Passengers Entering Central London During the Morning Peak Period (07.00-10.00)

1987	(000's)	Share (%)
British Rail	449	40%
Underground (net)	403	36%
LT Bus	79	7%
Total Public Transport	931	82%
Cars, Motorcycles and cycles	181	16%
Coaches, Minibus	21	2%
TOTAL	1133	100%

FARE ELASTICITIES

3. The following table shows long-term fare elasticities for peak time users on two bases. First, the own-fare elasticity calibrates the effect on passenger volumes of a 1% rise in the real fare of the mode concerned. Secondly, the conditional elasticity calibrates the effect on passenger volumes of 1% real fare increases on Underground, Buses and BR simultaneously. The elasticity estimates are derived from equations covering the early 70s up to the mid-80s.

Peak-time elasticities	Underground	NSE
Own - fare	- . 42	- . 3
Conditional	- . 12	N.A

4. The conditional elasticity is the more appropriate to a discussion of the effects of raising rail (and bus) fares across the board. The above estimates indicate that a 10% real fare increase across all public transport modes would reduce Underground peak-time demand by just over 1%. The effect on NSE peak-time demand could be smaller still (since the relative size of the NSE and Underground conditional elasticities should reflect the greater choice of transport modes generally available to the Underground user as indicated by the relative size of the own-fare elasticities). However, there are several grounds for believing that even these small effects are exaggerated:-

(a) fare increases alongside improved quality of service will not deter passengers to the same extent as fare increases associated with fixed quality of service (DTp acknowledge that improved quality of service has a positive effect on passenger volumes);

(b) the NSE elasticity estimate may not fully reflect recent trends towards more long-distance commuting within the NSE sector (from locations where rail is effectively the only realistic travel option) nor the reduced attractiveness of the Underground as an alternative mode of travel in the light of recent congestion on the network;

(c) some real fare increases should be possible before the elasticities take effect (reflecting the effect of rising real incomes in conjunction with a positive income elasticity of demand for peak-time rail travel). DTp assume this to be 2% pa in the case of the Underground and there is no reason for a lesser assumption in the case of NSE.

5. It is also worth recording that the effects of fare increases on passenger demand take some time to feed through. DTp assume that only 50% of an elasticity effect is felt in the first year following a real fare increase on the Underground. It takes 5 years for the full effect to be felt. Over such lengthy periods of adjustment, other factors will, of course, be at work (for example, employment growth in central London) which serve to increase rail patronage at peak times.

<u>EFFECTS ON ROAD CONGESTION</u>

6. Taking all of the preceding into account, it seems likely that across the board 10% real fare increases would cause less than a 1% reduction in peak-time travel on both Underground and NSE. In practice the effect should be as little as ½%.

7. So far as commuters into central London are concerned* a ½% elasticity effect amounts to around 4,000 travellers in total (using the table following paragraph 2). Not all of these travellers will be diverted to individual private transport (cars, motor cycles and cycles) especially given the difficulties of parking in central London. Some will switch to off-peak rail journeys and others will not travel at all (a proportion of peak-time journeys are currently undertaken in connection with leisure and tourism activities). Coach and minibus services should also

* No separate information is available on the absolute numbers of peak-time NSE and Underground users whose journeys do not encompass central London. Consequently, it is not possible to quantify the likely effects of rail fare increases in this wider area, although they will be consistent with the small elasticity estimates discussed above.

pick up some passengers. It is, however, possible that some travellers will react to fare increases by shortening the length of their rail journey (ie driving to a rail station closer in to central London). This could lead to increased parking congestion around rail stations, but would not be likely to have a material effect on traffic speeds in the outer suburbs.

8. Hence, it seems apparent that rail fare increases on the scale posited would lead to relatively small numbers of peak-time travellers switching to private road transport (specifically cars). Significantly less than 4,000 travellers into central London are likely to switch in this way following 10% real fare increases on all public transport modes.* This represents less than a 2% addition to peak-time private transport commuters into central London.

9. Once it is further recognised that commuters into central London represent only a small proportion of London road users at peak times (commercial traffic and those undertaking journeys across the suburbs are the major categories of user), it is likely that the effects of rail fare increases on any reasonable scale will be fairly insignificant in terms of adding to road use and congestion. Very rough estimates based on DTp traffic flow models suggest that 10% rail fare increases would ultimately reduce road traffic speeds by 1% (broadly equivalent to the annual rate of decrease of road traffic speeds observed in the central London area since the late 70s).

10. Any effects from fare increases could be more than offset by moves towards raising road user charges, particularly in central London, to a level which more closely reflects the (marginal) social costs of road use including congestion costs. Road tolling possibilities are being pursued by DTp in the context of the London Assessment Studies which cover future transport developments in four inner London transport corridors.

* Effects of fare increases on peak-time bus travel have been ignored, due to the very small share of bus travel relative to rail.

SUMMARY

11. This note has argued that:-

(a) the appropriate context for considering real fare elasticities is one in which fares are raised across all public transport modes;

(b) available estimates of fare elasticities indicate that peak-time passenger demand on NSE and the Underground are relatively inelastic;

(c) there are good grounds for believing that the true values of such elasticities are even lower (ie passenger demand is more inelastic);

(d) for a given rail fare increase, by no means all of those diverted away from peak-time rail commuting will switch to individual private transport;

(e) peak-time commuters into central London form only a small proportion of peak-time road users in London generally;

and hence,

(f) rail fare increases on any reasonable scale (10% has been taken for purposes of illustration) are likely to lead to relatively minor effects on London road use and congestion at peak times (this is further supported by rough estimates based on DTp traffic flow models;

(g) these small effects could be further mitigated by moves towards raising road user charges.

Phillip Morgan

PHILLIP MORGAN

PEAU

cst.pas/mc/3.21

CONFIDENTIAL

FROM: MARK CALL
DATE: 21 SEPTEMBER 1988

NOTED [illegible]

CHANCELLOR

cc Chief Secretary
Financial Secretary
Mr Anson
Mr Monck
Mr Moore
Mr Guy

Ch/
Mr Channon's ppr now arrived – behind
JS 21/9

BR PRIVATISATION

I met Greg Bourne of the Policy Unit at the Adam Smith Institute's seminar on Rail privatisation today.

CALL → CHEX 21/9

2. It appears, happily, that the Policy Unit have ruled out the Track Authority model of privatisation. The Adam Smith Institute continues to push it. Greg tells me that John Redwood has become much less enthusiastic about it, and in fact the CPS published a (rather poor) pamphlet advocating a regional split.

3. Greg Bourne also tells me that while robust on price increases, the Policy Unit are very nervous about closures. They are anxious that analysis of the economics of rural lines include the cost, and inherent subsidy, of the roads people face as an alternative mode of transport. This last point looks sensible.

4. Finally, Greg reports that Paul Channon would like to make a big splash on rail privatisation at the Party Conference. He has also accepted to speak on this at a CPS Seminar on 28 October and a further, larger Adam Smith Seminar on 2 November. Mr Channon is clearly looking for great progress on the 29 September.

[signature] pp

MARK CALL

Ct paper seen: (a) extraordinary that no mention is made of look at how other countries with private sector railways organise themselves (b) there is a strong case for going thro' all the closures & subsidy withdrawals before privatisation (as eg in steel): the less contentious privatisation is the [illegible] the threat of opposition [illegible] would otherwise oppose [illegible] on that account.

chex.dg/docs/22.9.3

CONFIDENTIAL

Jonathan

FROM: P J CROPPER
DATE: 22 September 1988

CROPPER → CHEX 22/9

CHANCELLOR

Thanks. What is the state of the railways in the US?

Cc: CST
Sir P Middleton
Mr Anson
Mr Monck
Mrs Brown
Mr Moore
Mr Guy
Mr Tyrie
Mr Call

PRIVATISATION OF BRITISH RAIL

A copy of Mr Channon's minute to the Prime Minister for the 29 September meeting arrive on my desk this morning. I hasten to get a note to your before your departure for Berlin.

2. In my view a strong case can be made out for believing that privatisation of British Rail would be a disaster. Rail is just not like the other nationalised industries, because it is permanently locked into unfair competition with road transport. In a pure market economy the railways would have been abandoned long ago, yet everybody except Sir A Sherman believes we should keep them as a public service.

3. That being so, I believe public ownership is the best framework. I accept that public ownership brings out the worst in both British management and British trade unionism, but in this case I believe it is the better of two evils.

4. The Channon paper says that British Railway will be generating enough profits by 1993 (with the help of public subsidy to the provincial services) to stand on its own feet in the stock market. But how long will that last? Remember the inter-war period when most railway ordinaries were worthless.

5. Come the next cyclical downturn in UK profitability - and there will be one - the railways will be on the rocks again. Then where does the finance for new investment come from? Not from borrowing in the market, once the ordinary shares have begun to pass their dividends. Not from share issues. So new investment will cease to take place, the quality of the rail service will deteriorate again, and everybody will come round to the ingenious solution of national ownership. I would give it five years.

6. Incidentally, I was appalled to see Paul Channon's paper saying:

> "Railways are competing primarily with the private car and long distance coaches in the inter-urban passenger market. Over the next 15 years on present figures road construction and improvement are unlikely to keep pace with growing traffic, so railways should be able to offer an attractive high speed alternative, especially for trips with an origin or destination near a city centre."

7. In other words, congestion on the roads is going to get worse not better over the next 15 years and the Government does not care a damn. I just do not see this happening: sooner or later, public fury is going to register, and this leg of Paul Channon's argument for rail privatisation will fall away.

8. If it is felt that for reasons of dogma we are obliged to make a move on Rail privatisation, let us choose one of the partial solutions and see how it goes. What about privatising Network South East? That will always be required for commuters, it covers the most prosperous and politically influential part of the country and it will enjoy the boost from tunnel generated traffic. This has the potential to be the profitable sector of British Rail for years to come: let the standards of service be set in the South East and then subsidise the services in the rest of country to bring them up to the same standards.

It gets an enormous subsidy

9. Alternatively, privatise Eastern Region and give it a try.

10. Essentially, my vote goes against private sector finance in either road or rail. To my mind this is the one area of government - apart from defence - where the market system breaks down and where we want a concerted programme of investment unrelated to profitability. The benefits of a swift, efficient and uncongested transport system will be reflected in greater economic efficiency and an improved quality of life throughout the rest of the economy: we will only weaken our economy if we try to get this planning done within the confines of a plc. Mr Channon says "It would be important to ensure that privatisation did not lead to poorer quality of service". We ought to be looking for ways of providing a better quality of service.

P J CROPPER

023JRF42.2

CONFIDENTIAL

FINANCIAL SECRETARY TO THE TREASURY

FF 23/6 ?

FROM: R C M SATCHWELL
DATE: 23 September 1988

SATCHWELL → PS/CHEX 23/9

PS/CHANCELLOR

cc PS/Chief Secretary
Mr Anson
Mr Monck
Mr Moore
Mr Guy
Mr Call

Note on this immediately behind.

BR PRIVATISATION

With reference to your minute of 22 September, and the Chancellor's comment about other countries with private sector railways, I should mention that the Financial Secretary has already commissioned briefing from PE on what happened in Japan when JNR was "privatised". Not only would this provide a useful case study of the transfer of railways form public to private ownership. Japan also seemed the best example of a major industrial country with large-scale private sector passenger railways, which might shed light on how a privatised BR might work in practice.

R.C.M.S.

R C M SATCHWELL
Private Secretary

048mdg42.2

PERSONAL

FINANCIAL SECRETARY TO THE TREASURY

FROM: FINANCIAL SECRETARY
DATE: 27 September 1988

CHANCELLOR

Ch, You will remember that we met Bland when we lunched at LWT some months ago.
JS 28/9

BRITISH RAIL

I notice from the papers on BR that we will soon be looking for a new Chairman to replace Bob Reid. I would like to suggest three possible candidates.

- John Gardner, Chief Executive of the Laird Group, owners of the rolling stock manufacturer Metro-Cammell. An extremely tough and competent businessman with some knowledge of the railway industry, who was once considered for the Chairmanship of BSC.

- Duncan Bluck, Chairman of the British Tourist Authority and former Chairman and Chief Executive of Cathay Pacific Airways. He is, in my opinion, somewhat underemployed in his current job.

- Christopher Bland, Chairman of London Weekend Television, and the ex-Chairman of an engineering company. Again a highly effective and tough businessman, who also knows the political scene well.

Thanks.

NORMAN LAMONT

BRIEF MOORE → CHEX 27/9

pe.sh.djlm.note.27.9

CONFIDENTIAL

FROM: D J L MOORE

DATE: 27 SEPTEMBER 1988

CHANCELLOR

cc: Chief Secretary
Financial Secretary
Sir P Middleton
Mr Anson
Mr Monck
Mr Phillips
Mrs Case
Mrs Brown
Mr Guy
Mr A Williams
Mr Lyne
Mr Morgan
Mr Cropper
Mr Tyrie
Mr Call

all these pps. Put on folder for meeting, together with pps. marked below (paras 4 + 11). 27/9

PRIVATISATION OF BRITISH RAIL

In his paper of 21 September, top-flagged Mr Channon seeks clearance for a statement at the Party Conference that the Government is reviewing the merits of different structures for a privatised railway industry. At the same time, he wishes to make clear that while there is scope for bus substitution the Government has no large scale rail closures in mind.

2. If approved, three groups of advisers would be appointed: to report on the structural options; on possible regulatory regimes, particularly in Network SouthEast (the London commuter services); and - a merchant bank adviser - on marketability. Decisions would be taken in summer 1989, with a view to legislation after the next Election and privatisations in 1993 or 1994.

3. You and the Prime Minister saw Mr Channon's earlier papers of February and July. The proposals are new to the other Ministers at the meeting. Mr Rifkind and Mr Walker may well be sensitive to the implications for closures of rural lines. There is a risk that the discussion will become preoccupied with the social, rural railway. There may be questions on why it is necessary to move so quickly and on how rail fits in with other privatisation possibilities after the next Election.

Thus pps. behind hurdle.

4. In your minutes to the Prime Minister of 4 March and 19 August (copied only to Mr Channon) you supported the general case for further work on rail privatisation. I recommend that you continue to do so, though distinguishing between the approach to the Provincial network and the rest. As the table at the end of Mr Channon's annex shows, InterCity, Freight and Network SouthEast should all be showing positive returns in the early 1990s. For these sectors, perhaps with some reorganisation, privatisation is a real prospect.

5. But the remaining Provincial sector, the rural and cross-country lines, is much more difficult to handle. Current forecasts suggest grants of around £350 m in the early 1990s, and there will be pressure to maintain heavily subsidised services. This is an area of Government expenditure which enjoys remarkable immunity from scrutiny for value for money. Irrespective of privatisation there is now a powerful case for a rigorous look at it, including the question of how far there is a role for the private sector in running these services and securing better value for money. This could be done as part of the privatisation exercise. Or it could be done in parallel and, initially at least, as an in-house rather than a consultancy exercise. I suggest running the latter option if at the meeting it becomes clear that the whole of the privatisation exercise risks being thrown out because of worries over the rural lines. In the mean time, Mr Channon should not be allowed to give sweeping public assurances that the Government has no large scale closures in mind.

<u>Timing and the main options</u>

6. If the privatisation of some major parts of BR is to be a possibility in the early 1990s it is essential for preparatory work to start now:

a. Following the Economist leak in the summer it is now widely expected that the Government is moving to privatisation, and there will be pressure for clarification. In particular, BR management is uncertain and needs a lead.

b. Reid's successor will be selected during 1989 for appointment in March 1990. This must be against the background of a clear statement of the Government's objectives for the industry - either to pursue privatisation options or to carry on with the present structure but with more ambitious objectives.

c. There must be sufficient time for any possible reorganisation, with establishment of accounting systems, managerial teams and the emergence of track records. For example, InterCity may be merged with Freight, as Transport suggest. Network SouthEast might be divided for privatisation between two companies: in the South East; and north of London stretching into East Anglia.

7. Mr Channon recommends that it is tactically best to commission a study of several options, rather than to constrain it too much at the outset. I can see the tactical sense of this but it will be important not to waste time on unpromising possibilities. I would make clear both publicly, and certainly to the consultants, that a national track authority looks unattractive. In deference to Reid, it is prudent to look at the option of privatising rail as a whole. But it should be said that the most promising option looks like a breakup, with privatisation of the parts not necessarily taking place at the same time.

8. It is in the course of this further consultancy work that there will be an opportunity to look in more depth at some of the questions which have been raised, eg, on lessons to be learnt from overseas systems. The advisers will also need to look at how vulnerable the profitable sectors are to downturns in the economy; the Transport papers acknowledge that there would be an effect though I would not be anywhere near so gloomy as Mr Cropper on this. Nor do I share his view that an improved road system would kick away a leg of the privatisation argument.

Network SouthEast

9. In earlier correspondence you pointed to the case for higher **real fare increases** in order to bring forward improvements in commercial returns. The Chief Secretary has pressed this argument

in the current IFR discussions. At present the position is that NSE are going for real increases next January of 3.6 (around 10% cash) rather than 2. But Mr Channon is reluctant to improve on the present assumption of 1½% real in later years until he has gauged the reaction to the 1989 increases. This is best pursued in the IFR context. But you could make the general point that there is a continuing case for close review of these increases both to improve prospects and to accelerate the reduction of subsidy to the well off South East commuters. It is also important that selective fare increases, and investment decisions, should be such as to minimise and preferably eliminate any loss making services within NSE.

Subsidy £5-6bn

10. Setting aside the rural services discussed below, the review of the case for **regulation** of the privatised BR will focus mainly on NSE. The argument is that some regime to control prices may be necessary to protect the captive commuter.

11. It might be argued in discussion of NSE that subsidies or low returns are justified in order to secure benefits from reduced **road congestion**. As you know, our own analysis suggests that even substantial rail fare increases would have relatively minor effects on London road use and congestion at peak times - Mr Morgan's paper which I sent to you on 16 September. I have now sent that paper to Transport to see whether they dissent, or are capable of producing anything themselves. If Mr Channon, or anyone else, were to refer to the question he might be asked to produce a paper, in agreement with us.

Side flagged behind.

Provincial sector and closures

12. If the sectors discussed above were privatised, in whatever combination, most of BR would then be in the private sector. But what should be done with the remaining mish-mash of rural and cross-country lines?

13. In national transport terms they are very expensive. On present policies, Mr Channon says they will still need grants of around £350 m in the early 1990s compared with around £500 million now. They would then contribute 22% of BR's running costs and 9%

of revenue. At the same time, and to quote from paragraph 10 of his Annex, "in overall transport terms the sector is insignificant, with fewer passenger miles than by motorcycle (less than 1% of total passenger miles by all forms of transport)".

14. We know little about the finances of individual lines, or of the case for keeping them open. In preparation for this briefing, Transport sent to me the examples of loss-making services shown in the Annex to this brief. They comment that the list includes some lines which they do not think Ministers would want to close. Transport should now be required to obtain from BR updated figures for <u>all</u> the individual loss-making lines and to summarise the case for continuing subsidies for each of them and the options for reduced subsidy and for bus substitution.

15. Transport should also summarise what is being done, and what is in prospect, for closing rail services and substituting with bus services (which can still be grant aided but which are cheaper). The problem here is that we seem to be kidding ourselves about the possibilities for progress under this head. <u>No</u> bus substitution services have been proposed so far. The whole process is subject to procedures whereby BR propose a closure, which is then examined by a public enquiry run by locals who do not pay for the subsidy but, not surprisingly, like the service. The procedure is long drawn out and vulnerable to judicial review. BR are therefore deterred from putting much effort into finding bus substitution candidates; and, particularly following Transport's dithering over the Settle/Carlisle proposals, they may think there is little political will for action. If the reality is that the present procedures are an undue constraint, what ideas do Transport have for legislation for alternative procedures?

16. These questions should be pursued irrespective of privatisation. But in the meantime does it make sense to talk of privatisation of these lines? As you have pointed out it would be best to move to a relatively settled subsidy regime, and to have implemented any closures, before privatisation. But under the present procedures it could be very difficult to do so by the early to mid 1990s. So full privatisation may be more distant for this sector, if ever. But there may be options for private sector

involvement which would lead to more efficient deployment of subsidies, eg, Transport are thinking of mini local track authorities which could franchise out to the private sector operator calling for the lowest subsidy support. ??

17. There is also a case for considering - perhaps in-house rather than publicly - whether Transport should be responsible for all these subsidised lines. In principle it is arguable that the Scottish and Welsh departments should have public expenditure responsibility for their rural services, provided we were convinced that in practice this would make them look more realistically at the grants. Transport are also considering the possibility of transferring responsibility for the grants from central government to the local authorities who benefit from them. But they are well aware of the worries that this could lead to profligate local expenditure.

18. Because this family of questions about the Provincial sector is so different to those on the other sectors there may be advantage in leaving the consultants to concentrate on the latter and to run a primarily in-house exercise on Provincial, possibly informed by the MMC report due later this year. The two possibilities are not necessarily mutually exclusive and the consultancy exercise could throw up some ideas and information for the Provincial sector. But I would not press this if concerns over the social railway and closures were such as to risk wrecking the whole privatisation review.

<u>Mr Channon's announcement</u>

19. It is important that if Mr Channon is to make a statement at the Party Conference its terms should be cleared with colleagues. I suggest that he should point to the very substantial improvements, achieved and in prospect, for the main revenue earning parts of the business. These open up the possibility of privatisation in the 1990s for these sectors, and this could give a further impetus to the improvements made. There are other parts of the railway - rural and cross-country lines - which are still receiving large subsidies and which pose different questions. Selective subsidies will continue but it is essential to get good

value for money from them. There must be progress in implementing the Government's policy on bus substitution. There may well be a role for the private sector in running bus and rail services on these lines.

20. But there should be no renewal of commitments against "large scale closures", which is ambiguous and a hostage to fortune pending a proper review of the subsidised lines.

Rail in the context of the privatisation programme

21. Assuming the present programme goes to plan in this Parliament, the main remaining nationalised industries after the next Election will be Rail, Coal, Post Office, London Transport and the Civil Aviation Authority. Energy Ministers have already announced the possibility of Coal privatisation. DTI have now resumed work on the possibilities for the Post Office's businesses (counters, parcels and mails). London Buses could be deregulated and broken up in trade sales once the necessary legislation is in place. So, setting aside the London Underground and the CAA, **Rail, Coal and the Post Office are all possibilities for major sales.** This could be a heavy privatisation programme, particularly if none of them are ready before the mid term of the next Parliament (cf our current problems with Water and Electricity). But I do not see this as a reason for opposing further work now on the Rail options.

Summary

22. I recommend that you strongly support the commissioning of work now on the options for privatising, in some form, InterCity, Freight and Network SouthEast. This work should focus mainly on breakup options, rather than on a national track authority or on privatising Rail as a whole. It should scrutinise rigorously the profit forecasts and the accounting basis for proposed reorganised businesses. It should look at the lessons from overseas rail administrations insofar as these seem useful.

23. For the remaining Provincial lines there should be a review covering:

i. the losses (including where possible attributed overheads) and subsidy on each line;

ii. an analysis of which lines merit continuing, reduced or nil subsidy and why;

iii. the scope for closure and bus substitution under existing statutory procedures and the case for less constraining procedures;

iv. the scope for private sector participation in on-going subsidised lines, eg, running them under franchise.

It could be preferable to let the consultants look at the whole of the railway, including the Provincial sector. But, rather than lose the whole privatisation exercise because of worries over Provincial, it could if necessary be covered by a separate in-house review.

24. Mr Channon's announcement should be cleared with colleagues and might be on the lines sketched out in paragraph 19 above. Pending a review of the Provincial sector, he should not give long term commitments to avoiding "large scale closures". Rather he should say that selective subsidies will continue.

D J L MOORE

CONFIDENTIAL

BRITISH RAIL

EXAMPLES OF HEAVILY LOSS-MAKING SERVICES

	Operating Loss[1] £m	Subsidy per £1 of revenue £
Ladybank-Perth	0.16	8
Gainsborough-Barnetby	0.20	7
Knottingley-Goole	0.20	7
Fort William-Mallaig	0.60	6
Burnley-Colne	0.32	6
Inverness-Thurso-Wick	2.30	4
Inverness-Kyle of Lochalsh	0.60	4
Barrow-Carlisle	2.4	3
Machynlleth-Pwllheli	1.3	3
Swansea-Shrewsbury	0.7	2

NB. (1) excluding overheads, which add on average 50%. They cannot simply be allocated pro-rata to direct costs and may not be avoidable in the short-run.

25/9/89.

SECRETARY OF STATE FOR TRANSPORT

CH/EXCHEQUER
REC. 26SEP1989
ACTION CST
COPIES TO

26/9

Prime Minister

FST
[illegible] [illegible] (successful) [illegible] the Japanese privatisation [illegible] their State railways.

BRITISH RAIL

1. I hope to be able to write to you soon about a successor to Sir Robert Reid. Meanwhile I need to set new objectives for the next three years and give my consent to some helpful changes Sir Robert has proposed in BR's organisation. They will give a further impetus to improving BR's commercial performance and help to pave the way for privatisation in due course if that is what we decide to do, but without committing us in any way. My view is that his proposal presents us with a good opportunity that we should take.

2. The studies set in hand by Paul Channon have made good progress. The prospects for privatising British Rail's Freight and Inter-City passenger businesses by the mid-1990s are promising, provided that economic growth is sustained and that BR achieve further efficiency improvements. The London commuter services could become a viable business a little later. Provincial passenger services would need substantial, though reducing, subsidy.

3. The railways' efficiency and financial performance have improved substantially in recent years. It is essential that they continue to do so. The financial objectives I shall be giving BR shortly for the next three years have that aim in view.

4. We shall have to decide in due course whether BR should be privatised. I have now received reports on possible structural options and the regulatory regimes and subsidies that would be necessary. I shall be examining these in detail over the coming

SECRETARY OF STATE FOR TRANSPORT

months. It is however already clear that if privatisation goes ahead, be it as a whole or in parts, fairly radical organisation and accounting changes will be needed. Our experience with privatising electricity has convinced me that it is very desirable to get such changes in place well in advance of the actual privatisation. I therefore want to make a start now.

[!]

5. BR's existing organisation divides responsibility in a complex way between:

- the businesses (sectors), which specify and market services and are responsible for bottom line performance;

- the regions, which are the production units supplying the services the sectors want. They own most of the assets and employ the operating staff;

- the functions (civil engineering, mechanical engineering etc) which provide central technical services.

6. Sir Robert Reid has recently put a proposal to me for changing this structure so as to put all these activities under the direct control of the commercial businesses. The proposal will involve re-allocation of assets and personnel. But it will greatly clarify responsibilities and accountability and help to reduce costs. A large measure of autonomy would be given to the individual businesses and BR headquarters might become a small holding company.

7. I think that this takes us in the right direction. It is desirable in its own right; and it will help to make privatisation easier without committing us to it in any way. One of its great attractions is that the work needed to develop the new accounting

SECRETARY OF STATE FOR TRANSPORT

arrangements, (including the proper allocation of joint costs and assets, and the preparation of balance sheets for each business) will cover most of the work needed to restructure BR for privatisation. The only structural option it would rule out would be one based wholly on regional companies. But that looks a very unattractive option because nearly every regional company would have a mixture of subsidized and commercial operations. If privatisation is to be successful we must restrict the need for subsidy to one or perhaps two companies and be able to privatise the rest on a fully commercial basis. With purely regional companies this would not be possible. There may be a case for regional companies in Scotland (wholly subsidized) and the South East (fully commercial). Sir Robert Reid's organisational changes could preserve that possibility. Any new Chairman of BR would be bound to wish to simplify BR's byzantine management and structure and so I see no reason to delay these changes.

8. I therefore propose to:

set BR new 3-year objectives which will:

(a) move the Inter-City and Freight businesses towards full commercial viability as quickly as possible;

(b) remove subsidy from the London commuter services and require the sector to plan for a full commercial return;

(c) recognise that subsidies will still be needed for the heavily loss-making Provincial services, but at a lower level than now;

endorse the Chairman's proposals for an interim reorganisation.

SECRETARY OF STATE FOR TRANSPORT

9. I should be glad to know whether you are content that I should proceed on these lines. I shall of course discuss the details of the new financial objectives with the Chief Secretary, and consult the Secretaries of State for Scotland, Wales and the Environment on issues that concern them.

10. I am sending copies of this minute to the Chancellor of the Exchequer, the Secretaries of State for Wales, Scotland and the Environment, the Chief Secretary and Sir Robin Butler.

C.P.

CECIL PARKINSON

25 September 1989