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David Heyhoe Esq
Private Secretary to the Lord Privy Seal
68 Whitehall
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14 February 1984

Dear David,

SHIPPING SUBSIDIES FOR THE SCOTTISH ISLANDS

My Secretary of State plans to make an announcement shortly concerning subsidies in the coming year for shipping services to the Scottish islands. Since the announcement covers his decision not to pursue further the move towards a system based on Road Equivalent Tarriff, to which a commitment was given in the Scottish Manifesto in 1979, the announcement is likely to be controversial. Mr Younger believes that if possible it should take the form of an oral statement. An early announcement is necessary to enable the operators to fix fares for the coming summer and if it is convenient we would like to make the statement on Tuesday or Wednesday of next week. I would be grateful if you could seek the Lord Privy Seal's agreement to this.

I am attaching an early draft of the proposed statement to explain the background. I am copying this letter to Tim Flesher (No 10), John Gieve (Treasury), Murdo Maclean (Chief Whips Office) and David Beamish (Lord President's Office).

Yours sincerely

John Graham

J S GRAHAM
Private Secretary

SCOTTISH SHIPPING SUBSIDIES: DRAFT STATEMENT

With permission, Mr Speaker, I should like to make a statement on my proposals for financial assistance in 1984/85 for shipping services to the Scottish islands, and also to announce my conclusions on the future system of shipping subsidy.

I propose to give deficit grants of £7.2m to Caledonian MacBrayne and of £0.9m to the Orkney Islands Shipping Company. These grants will imply a need in both cases for the companies to increase their fares by approximately 5 per cent overall for the year. I propose also to increase support offered to P & O and to the various bulk shipping companies with whom I have Undertakings, to allow them to continue to rebate the fares and charges on their services. I propose to leave unchanged the percentage rates of rebate, except that in the case of P & O's services provision will be made to allow a 60 per cent rebate on fares for students and all schoolchildren cases for the companies to increase their fares by approximately 5 per cent overall for the year. I propose also to increase support offered to P & O and to the various bulk shipping companies with whom I have Undertakings, to allow them to continue to rebate the fares and charges on their services. I propose to leave unchanged the percentage rates of rebate, except that in the case of P & O's services provision will be made to allow a 60 per cent rebate on fares for students and all schoolchildren resident on the islands. The rebates are estimated to cost £3.65m in the case of P & O and £1.6m in the case of the bulk shippers.

In total, Government revenue support in 1984/85 will amount to some £13.35m, an increase of 9.9 per cent over the sum which I estimate will be required in the current financial year. I am therefore once again increasing in real terms the resources available for shipping subsidy, and I hope this will be recognised as an excellent deal for the users of these services. It is also worth recalling that since 1979 I have increased these resources threefold from £4.14m to the figures I have just announced.

I do not propose a radical change in the basis for distributing subsidy. We undertook in 1979 to re-examine the structure of shipping subsidies and to "increase them in real terms as part of the process of moving closer to road equivalent tariffs". Our re-examination resulted in early progress in extending subsidies to the North Isles services and to the bulk shippers and overall subsidy has been increased substantially in real terms in each year since 1979. I have however concluded that a change to an RET-based system of subsidy should not be pursued.

There are several reasons for this. First, I estimate that full RET implemented on a basis that would be acceptable to the more remote island communities, would produce a subsidy bill of at least £23m, without allowing for the extra investment costs that would be generated by increased demand. In the light of our overall objective to contain public expenditure it is unrealistic to expect such increases in financial provision. I am also conscious that since under RET the subsidy requirement each year would arise from the automatic application of formula, unrelated to shipping costs, that requirement could change dramatically from one year to the next. Sudden increases in subsidy could only be achieved at the expense of other services for which I am also responsible.

Second, it has become particularly clear in the last two or three years that a period of major new capital investment for our shipping services lies ahead. Caledonian MacBrayne's new Arran vessel was launched last December and is now being fitted out for the 1984 season. I have recently approved the Company's investment proposals for a further new vessel to replace the MV Hebrides. I am giving substantial financial assistance to P & O for the refurbishment of the St Clair. A decision will be required soon on the replacement of the MV Orcadia, which provides internal Orkney Islands services. Forthcoming terminal developments include expenditure of around £5m at Uig, Tarbert and Lochmaddy and major reconstruction of the ferry terminal at Scrabster. Work has recently been completed on pier improvements on Tiree, and further financial assistance will be required to improve the steamer berth at Mallaig and the pier at

Tobermory. There is therefore substantially more public expenditure on our shipping services than is indicated by the annual revenue grants alone. Third, I have given weight to the Monopolies and Mergers Commission's general recommendation that fares should, in the interests of efficiency, be related to costs incurred. It is inevitable that under RET, where fares would be unrelated to costs and Government simply obliged to pick up the balance of costs, operators would tend to become inefficient. Since there will always be only a finite sum available for support of shipping services, inefficiency of operation could only endanger future investment in new vessels and terminals, to the detriment of the quality of services in the longer-term.

I am however conscious of the desirability of having a fares system that is clearly understood. P & O and the bulk shippers are private sector operators who fix their fares and charges on a commercial basis, the charges being rebated with the benefit of subsidy. These arrangements will continue. In the case of Caledonian MacBrayne the Monopolies and Mergers Commission noted the company's policy that fares on one route should be comparable with those on another, and that a standard fare scale should be adopted consisting of three elements, pier dues, toll charges (reflecting the cost of loading) and distance charges. Such a system should produce a structure of fares tapering with distance. The Commission noted that no recent progress had been made with this system and that as a result significant anomalies now exist in the fare structure. They recommended that Caledonian MacBrayne should make renewed progress towards such a system, starting with an up to date examination of the structure of costs. I have asked the Company to proceed on this basis. The new fares system will take some years to implement fully, but a start will be made in fixing the charges for 1984/85, which the Company will be announcing shortly. The result will be a standard fares system which should be more equitable than at present.

I am aware that my decision not to proceed with road equivalent tariff will cause disappointment in some quarters. However the

question I have had to address is how, in the light of some significant developments since 1979, we can offer the best long term guarantee of services to the Scottish Islands. My subsidy proposals for 1984/85 and the substantial capital commitments which I have mentioned, confirm my continuing commitment to the maintenance and improvement of these services.