P.01354

PRIME MINISTER

British Rail's Inter-City Strategy: E(NI)(84)8

BACKGROUND

It has long been Government policy that the Inter-City sector of British Rail should be treated as a fully commercial enterprise. It is in direct competition with other forms of transport; and Ministers have seen no social or other justification for subsidy. It should therefore cover its costs and make an acceptable return on capital.

2. The financial results of Inter-City have fallen well short of this. The Government has tried in various ways to press BR for improvements. Since 1981, for example, it has refused to approve the East Coast Main Line electrification in advance of the production of a satisfactory strategy for Inter-City and satisfactory progress towards improving efficiency.

FLAG A

3. In his memorandum E(NI)(84)8 the Secretary of State for Transport suggests that the strategy which BR have now produced, summarised in Annex to his memorandum, is broadly satisfactory. Inter-City should be within reasonable distance of its financial target by 1988-89: the shortfall is some £29 million (5 per cent of turnover), and it should be possible to find savings on this amount.

4. The division between Inter-City and other lines is not clear cut; and the strategy envisages some switches between Inter-City and other sectors. Mr Ridley suggests that this is reasonable; but that there should be no

further switches afterwards. The aim is to prevent BR meeting targets for the Inter-City Sector by changing the coverage of the sector.

5. Finally, Mr Ridley proposes that from 1988-89 Inter-City should become ineligible for subsidy through the Public Service Obligation (PSO) grant. This is a logical reflection of treating Inter-City as a fully commercial enterprise.

MAIN ISSUES

6. The issues before the Sub-Committee are as follows:

i. Is BR's proposed strategy for Inter-City broadly acceptable?

ii. Are the conditions proposed by Mr Ridley in paragraph 12(1) to (3) of E(NI)(84)8 satisfactory? Should any others be laid down?

iii. When should the Government's decisions be made known?

Acceptability of the strategy

7. There is a basic difficulty in assessing the financial viability of a sector of a "system" business such as British Rail. The definition of the services coming within the sector is inevitably somewhat arbitrary, and difficult judgements have to be made about allocating infrastructure costs. These issues complicate consideration of the proposals in Mr Ridley's paper. Inter-City comes into profit by 1988/89 partly as a consequence of re-definition (£11 million gained by bringing in the profitable Victoria-Gatwick and Liverpool Street-Norwich/Harwich services) and partly (to the extent of £60 million) by changing from the "prime user" to "sole user" method of allocating infrastructure costs. Mr Ridley claims that the new method is "more logical and justified", but there is in fact no adequate explanation of the change in either paragraph 6 of the main paper or paragraph 15 of the Annex.

8. The Chancellor of the Duchy of Lancaster has drawn attention to the accounting changes in his minute to you of 23 July. I understand however that he is not correct in implying that £71 million of the profit improvement between 1984/85 and 1988/89 is due to redefinition and reallocation of costs. The £60 million reduction in costs arising from the sole user method is built into the 1984/85 baseline. Of the £103 million improvement forecast by 1988/89, £25 million comes from sector redefinition and accounting changes. The problem nevertheless remains. It could well be that for management reasons it is legitimate and desirable to define Inter-City and allocate its costs in a way which makes commercial viability attainable. But we have to remember that the remainder of the business is to that extent less profitable.

9. Putting aside these complications, the strategy appears to be more realistically based than earlier attempts and contains some plans for real cost savings (albeit only some £47 million by 1988/89) which are said to rest on commitments made by the managers who have to implement them. There is however a shortfall of £29 million in meeting the financial target in 1988/89. Mr Ridley proposes that BR should be told that the Government expects future improvements to make up that shortfall. We understand that Treasury Ministers are likely to argue that the strategy should not be approved until BR have come forward with specific proposals for achieving the savings of £29 million needed to meet the financial target.

Conditions

10. In addition to dealing with the question of the £29 million, Mr Ridley proposes two further conditions (paragraph 12(2) and (3)): that there should be no more improvements through redefinition; and that PSO grant should not be available for Inter-City from 1988/89 onwards. The former is likely to be agreed. On the latter, some members of the Sub-Committee may wish to go further.

11. As Mr Ridley admits, there is a risk that Inter-City, without PSO grant, will still make losses. He suggests that the response to that might be to allow BR to borrow more. But Treasury Ministers, in particular, are likely to argue that the presumption should be that BR will find economies to avoid any losses: a possibility that those economies might include route closures should not be ruled out. The figures in paragraph 13 of Annex A to E(NI)(84)8 show that even in 1988/89, cross-country routes within the Inter-City sector will be making losses of some 25 per cent of turnover. Since there is presumed to be no social justification for subsidising such routes (hence the withdrawal of PSO grant) the case for closure - political objections apart - must be strong.

12. Ministers may also wish to consider whether it would be right to remove the PSO grant from a date earlier than 1988/89. On the one hand, if there is no social justification for subsidising Inter-City, it is illogical to stop paying grant only when the Sector is expected to reach its financial target. If cessation of grant is linked too closely with financial viability, it may be difficult to stop payment if financial results are worse than expected. On the other hand, Mr Ridley may argue that to withdraw grant too quickly would demoralise management.

Timing

13. If Ministers approve the proposed strategy there is no tactical reason vis-a-vis the management for not telling the Board of that approval. But Ministers may wish to consider whether there is anything to be gained from delaying an announcement in terms of leverage over the rail unions during the coal strike.

HANDLING

14. You will wish to invite the Secretary of State for Transport to open the discussion. You might then ask the Chief Secretary, Treasury to comment. The Secretary of State for Employment may have views on timing and tactics vis-a-vis the railway unions.

CONCLUSIONS

15. You will wish the Sub-Committee to reach conclusions on the following.

i. Should the Inter-City strategy as proposed in E(NI)(84)8 be approved?

ii. If so, should the approval be subject to conditions:

a. as proposed in paragraph 12(1) to (3) of E(NI)(84)8;

b. additionally?

iii. When should the Government's approval be conveyed to the British Rail Board?

PLG

P L GREGSON

25 July 1984