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PRIME MINISTER

British Rail (BR) Corporate Plan
(E(NI)(85)4)

BACKGROUND

The Secretary of State for Transport circulated a review of British Rail's 1984 Corporate Plan with his letter of 28 February. He suggested that collective discussion of BR's strategy should be postponed until 1986, when the current Chairman's term ends, with the aim of setting new medium term objectives in the light of the 1985 Corporate Plan (which would take into account the impact of the miners strike.) Your Private Secretary's letter of 18 March recorded your wish for an early E(NI) discussion, in particular of BR's proposals for greater efficiency and for manpower.

Proposals

2. Mr Ridley's paper, E(NI)(85)4, takes account of recent developments, such as the ending of the miners'strike and the BR pay settlement, but otherwise sticks to the same line as his earlier letter. Essentially he argues that the BR Chairman, Mr Reid, is doing a good job, that progress is being made towards the achievement of the current targets, that the 1984 Plan is now rather overtaken by events, and that Ministers should therefore postpone formulation of new medium-term targets until 1986, when they can be discussed in the light of the 1985 Corporate Plan.

MAIN ISSUES

3. No-one has suggested that BR's main current targets (to reduce the Public Service Obligation (PSO) grant to £635m in 1983 prices by 1986, a reduction of almost 25% in real terms; to earn a 5% real return on capital in the Freight business by 1988; to earn a 5% real return on

Inter-City, and remove it from subsidy by 1988/89) are too soft. Rather the worry is that they will not in the event be met. The Freight target is particularly vulnerable, given the reduced traffic and reduced rates likely to follow on from the miners strike, but the Inter-City target is also in danger from low traffic growth. Mr Reid has not asked for any revision, and has said that BR will strive to meet the targets. Assuming that Ministers accept that there is little extra that can be done immediately, that the current targets should run their course, and that new targets should not formally be set until next year, the main issue is what guidance Mr Reid should be given in preparing the 1985 Plan on:

(i) the future of the Freight business;

(ii) the development of Inter-City;

(iii) the financial performance and future size of the provincial sector;

(iv) pay and productivity:

(v) the timing of the review of BREL;

(vi) other disposals, particularly property;

(vii) the longer term.

The Freight Business

4. BR's market share is down to about 3%; it faces effective competition for the remaining business. The miners'strike cost BR £250 million in lost revenue. Mr Reid has ordered a review of the prospects for the freight business which is still in progress; it may well conclude that BR will lose further coal and other traffic to road haulage, and that the CEGB will squeeze BR's

margins in the forthcoming negotiations on power stations coal. This two-way squeeze will make the 5% return target difficult to achieve unless further cost savings can be found; both productivity improvements (eg driver only trains) and capacity reductions are likely to be needed. Cost allocations between BR's business sectors, which share common infrastructure, are notoriously difficult, but care will need to be taken to prevent costs simply feeding back into the passenger business as a consequence of any freight cutback. An increase in road freight volumes, whether a result of deliberate BR action or not, is likely to be a tricky political issue.

Inter-City

5. The present target is based on over-optimistic revenue forecasts, but Mr Ridley argues that it should be retained as a spur to efficiency. The main hope for improvement lies in reducing costs; there is little or no scope for real increases in the general level of fares, which simply result in lost business because of the tough competition BR faces from long distance coaches. It is too early to assess the impact of BR's new advertising campaign and its recent simplification of its fare structure.

The Provincial Sector

6. Rural services are a serious drain on BR's resources. Income covers about a quarter of costs; the sector absorbs around half the PSO grant. There is little scope for fare increases, and BR must look to improved efficiency if the grant burden is to be reduced. The main area for cost reductions probably lies in bus substitution (where BR have identified scope for replacing up to 75% of provincial services.) As Mr Ridley says, this will need careful handling and a gradualist approach, but can be presented positively - buses should provide a more flexible and frequent service than the trains they replace. Bus deregulation will lead to important changes in the market,

and provides an opportunity for BR to introduce changes which could be more difficult once the market has settled down.

Pay and Productivity

7. BR achieved a reasonable settlement as a result of their decision to decouple pay and productivity for the first time for some years. As noted above, improving productivity is a key requirement if BR's financial performance is to improve. Despite a 20% reduction in manpower since 1975, BR's annual wage bill for railway operations is about £1½ billion, roughly three times the current level of capital expenditure. 6,000 administrative staff have been removed over the last 18 months, but union attitudes have hampered progress on the industrial front. The four major areas outstanding from those identified in 1981, and listed in the Annex to E(NI)(85)4 show how far there is to go. The 1984 Corporate Plan envisages an 8% reduction in manpower over the next 5 years, but the real reduction in total costs is projected to be more than offset by improved pay and conditions. It must be doubtful whether traffic growth warrants such an increase in real labour costs.

8. Mr Reid's approach is, following the failure of national negotiations, to seek improvements through local management action, whilst strengthening BR's industrial relations side with new blood from outside. It is difficult to assess how successful this is likely to be; the essence of such a strategy is that it must be gradualist and opportunistic, as well as cumulative. But the alternative is to provoke an early confrontation with the unions which Mr Reid does not want, and which BR may be unable to carry through. There is of course a risk that a confrontation will arise anyway over a local productivity initiative, but BR would be able to respond more flexibly than in the case of a dispute initiated at national level.

BREL

9. The future of BREL is to be discussed separately before the summer recess. Mr Reid's review, which has yet to be received, has been delayed by the miners' strike and by uncertainty within BR about the future generally. The main alternatives may prove to be further painful slimming of the workforce, followed by privatisation (either as a monolith, or of individual units), or simply closure (because even a slimmed down BREL would be an unattractive proposition given the UK's basic engineering overcapacity.)

4,850 redundancies announced today.

Other disposals; property

10. Now that Sealink, Seaspeed and the BR Hotels have been sold, the main scope lies in further disposals of BR's considerable property holdings. The Monopolies and Mergers Commission Report due to be published shortly is critical both of BR's performance, and the effect of Government pressure on disposal proceeds. Some of BR's land is difficult to sell, but there should be scope for improvements following on from the MMC report.

The Longer Term

11. The aftermath of the Serpell Report effectively suspended discussion of more radical options for the longer term. Ministers are considering the future privatisation programme at today's E(A). BR is one of the industries where the Chancellor is suggesting further work should be done to examine the options. Mr Ridley may expand on private operation (paragraph 12) at the meeting.

HANDLING

12. You will wish to invite the Secretary of State for Transport to introduce his paper. The Chief Secretary will wish to probe efficiency savings that could influence this year's Investment and Financing Review, and the prospects for further disposals, particularly BREL, but also of BR property holdings. [redacted]

CONCLUSIONS

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

(i) The timing of further discussion of new medium term targets, either next year, in the light of the 1985 Corporate Plan, or on some other basis;

(ii) What, if any, guidance should be given to Mr Reid in preparing the 1985 Plan on:

(a) the Freight business (productivity, capacity);

(b) Inter City (cost savings);

(c) the provincial sector (cost savings, bus substitution);

(d) pay and productivity generally;

(e) the review of BREL;

(f) other issues, eg property disposals;

(g) the longer term.

PLG

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15 May 1985