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cc BS

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon John Moore MP
Secretary of State for Transport
Department of Transport
2 Marsham Street
London
SW1P 3EB

31 July 1986

Dear John,

BR OBJECTIVES

Thank you for your letter of 25 July reporting the outcome of your further discussions with Sir Robert Reid.

While I appreciate the importance you attach to securing the Chairman's full commitment to the PSO target and all the work you and he have done, I cannot accept that we should settle for the £555 million you propose.

I do not press for an assumption of higher real fare rises in the London area than 1½ per cent per annum, though I do not rule this out as an option.

But it is in the area of cost reductions that I am most disappointed by your proposals. When I agreed a target range of £470-£520 million for the PSO grant with Nicholas Ridley in March, this was on the basis - hardly too radical - that BR should be able to repeat the real reductions in general costs they had achieved from 1983 to 1986-87 over the next 3 years. I understand that on the latest figures, such a reduction in overall costs would produce a grant level of more than £100 million below what you are proposing, as a result of BR's more recent buoyant revenue. I appreciate that past movements in overall costs have been distorted by BREL redundancy costs and by the pattern of revenue investment. But even excluding these costs, and looking at basic costs, your proposal is consistent with a reduction in costs of 1½ per cent per annum over the next 3 years rather than the 2.2 per cent per annum the Board have achieved since 1983. Since a repeat of the performance since 1983 would produce a grant level very close to the top end of the original range I had agreed (£520 million),

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I must ask you to reconsider. I think it right to be tough with BR; as your E(NI) papers brought out they have not been as effective as they should have been in improving their efficiency and reducing their unit costs.

You would not in any event be able to announce a new PSO target at this stage, since several details remain under discussion. I do not therefore see the need to agree a target - which will inevitably be subject to later adjustments - at this stage and I am not persuaded of the need to go above the original range of £470-£520 million that I agreed. Have you considered the possibility of an efficiency audit carried out by outside consultants which could identify the opportunity for further efficiency savings to help them meet the target we set?

I also consider that the level of PSO grant should be decided at the same time as the rate of return for BR's commercial businesses. Here I am concerned about the overall 3 per cent target return that you propose. The current Government target for Inter-City, as you know, is a 5 per cent real rate of return by 1988-89. I realise why this cannot be achieved, but I think that we must seek a more ambitious target than simply breaking even a year after Inter-City will be ineligible for grant. Equally, I think there should be a more ambitious target for the Parcels sector than BR have proposed. For these reasons, I would prefer a rate of return target nearer to the overall NI target of 5 per cent than your proposal. Indeed, even a 5 per cent target would be somewhat generous as the assets of BR's commercial businesses are almost certainly undervalued.

I am copying this letter to members of E(NI), to Nicholas Edwards, and to Sir Robert Armstrong.

Yours ever,

JL

JOHN MacGREGOR

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DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

01-212 3434

CONFIDENTIAL 25 July 1986

The Rt Hon John MacGregor OBE MP
Chief Secretary
H M Treasury
Parliament Street
LONDON SW1

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Dear John,

BR OBJECTIVES

At E(NI) on 15 July I was invited to agree with you the targets we propose to set BR for grant and the rate of return on their commercial businesses for Sir Robert Reid's further 3 year term of office. I am now writing to let you know the outcome of the further discussions I have had with him.

attached

My aim was to get as close as possible to the target range of PSO grant which you and Nicholas Ridley agreed earlier in the year to ask the Chiarman to try for. At the same time, for the reasons I explained at the E(NI) meeting, I regard it as essential to have the Chairman's full commitment to the figure: it cannot be one that we impose on him against his better judgement. He needs to be able to sell the figure to his Board and management as a tough but realistic target which he is reasonably confident can be attained. The fact that Sir Robert was wholly committed in this way to the targets he was set in 1983 accounts in large measure for the success the Board have had in reducing their call on grant over the past 3 years.

My discussions with Sir Robert were based on the Board's latest forecasts contained in Strategy Documents which your officials have seen. Unfortunately in the last couple of weeks the Board have discovered arithmetic errors underlying some of the figures which bring the forecast grant requirement for the Network South East (NSE) and Provincial sectors to some £640m in 1989/90 (at 1986/87 prices) instead of the £620m we had previously been working on. That made the gap £20m wider than we had expected. I had also been looking to increases in real fares in the London area to contribute savings of some £30m in the target year. This was based on real increases of 2-3% per annum. Sir Robert made it clear to me that he was very uncertain whether the Board could deliver increases as high as this. I was also mindful of the comments made by colleagues on this point during our discussions.

Sir Robert Reid has nevertheless agreed to aim for increases of some 2% although he thinks it would be unwise to rely on more than 1.5%. That reduces the prospective savings by a further £10-15m.

In the light of all this, Sir Robert argued very strongly that the largest saving he could offer was £60 million - £15 million from fares increases and £45 million from deferring investment, the identification of additional benefits from investment already planned, and from further productivity savings he could clearly identify now. This would bring the grant down to £580 million in the target year. I impressed on him however the need for further reductions in the Board's basic costs; they have fallen by some 2.2% per annum over the last 3 years but looked set to remain pretty constant over the next 3. The savings Bob Reid had already volunteered included cuts in basic costs of around £15m. After further discussions he has now agreed to aim for further productivity savings of £25m bringing the total reduction to £40m, although the Board have not yet been able to develop specific proposals for achieving these extra savings. It would bring the reduction in the Board's basic running costs to 1.5% per annum over the next 3 years and reduce the grant requirement to £555m. Sir Robert has assured me that at this figure he expects to achieve the Board's quality of service targets. But he also made clear that this is the furthest he feels able to go. But for the extra costs of £20m and the £10-15m reduction in the prospective savings from London fare increases, it would of course have met the upper end of the target range Nicholas Ridley set.

I therefore propose to set the Board this target for 1989/90. It represents in total a reduction in grant of £180m compared with the target for the current year, and is in my view both challenging and realistic. It is by no means free of risk; apart from the fact that the Board have not yet identified the ways in which they would achieve the additional productivity savings, the Board's forecasts incorporate assumptions about growth in receipts in NSE quite apart from the results of real fare increases. 1985/86 was a year of exceptional growth but this may be partly explained by one-off restructuring of fares and the introduction of Capitalcard. There are no equivalent factors to support the forecast increase in 1986/7. If the growth forecast in 1986/7 and beyond does not materialise, some £30m would be at risk. If in addition part of the £20m growth in revenues last year proved to be a transitory phenomenon, that could be at risk also. The Board might recoup that by further real fare increases above 2%, but we would have to be prepared to stand by them in defending increases of that kind.

My officials are currently having discussions with BR about various accounting changes including the attribution of interest between the Sectors and the calculation of the Special Replacement Allowance which is intended to bring BR's historic cost depreciation provision broadly up to a CCA basis for grant purposes. These changes are likely to lead to some downward adjustment in the grant figure. If we decide to introduce a separate Police grant that will also reduce the PSO grant (by some £10 million) but we shall of course have to allow for the Police grant itself (some £15 million). We are also still discussing with the Board the accounting treatment of the BREL redundancy costs. That could lead to a change (upward or downward) in the grant requirement in the target year. We shall be aiming to conclude all these discussions during the summer so that they can be incorporated in the published grant target. My officials will of course keep yours closely in touch.

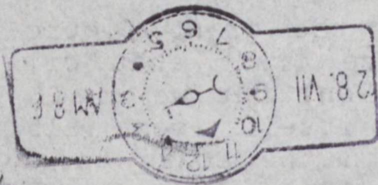
I am still discussing with Sir Robert the target rate of return on the "commercial" businesses. He is still aiming - despite considerable risks on both costs and revenue forecasts - for a 5% rate of return on the freight business and a broadly comparable one on freightliner. Clearly InterCity will not be able to do much more than break even in 1989/90, though I shall be looking for a significant improvement in the early '90s. The other commercial business is parcels where the Board are currently suffering unexpected losses as the result of the loss of the Post Office parcel business and the Murdoch group newspapers. In the light of this and the position of InterCity Sir Robert feels that it would be unrealistic to aim for an overall return of more than 2.2%, which might be increased to 2.5% by the proposal I am still examining to pay a separate grant towards BR's police costs. I am still discussing these points with him in the hope of increasing the overall target to 3%. These figures exclude future assets relating to Channel Tunnel trains which will have to be considered separately.

I regard the commitment by BR to take Inter City out of grant and expose it fully to competitive disciplines as a considerable achievement. If we can get them to agree to a 3% target return on their commercial business as well as the reduction of grant to £555 million we shall have done very well. We can rely on Bob Read to give his full backing to the figures he has signed up for and to improve on them if he can.

Copies of this letter go to members of E(NI), to Nicholas Edwards and to Sir Robert Armstrong.

Yours ever
John

JOHN MOORE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