CONFIDENTIAL

J Vereker
A. Duguid
A. Walters

DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

2

[E folw].

The Rt Hon Leon Brittan QC, MP
Chief Secretary to the Treasury
Treasury
Parliament Street
LONDON SW1

22 September 1981

Dear Leon

NATIONALISED INDUSTRIES INVESTMENT AND FINANCING REVIEW

I am now able to write to you about British Rail's finances for 1982/83. My officials have been in touch with yours about the three smaller transport industries. I have now seen your paper E(81)92 which is to be discussed tomorrow.

BRB's forecasts of their external financing requirement for next year have however worsened in the light of later information, since these were last considered by E, and now stand at £1113m. This further deterioration, to which you refer in E(81)92, erodes the economies which the Board identified when the extent of their trading problems became evident earlier in the year. I have now discussed with Sir Peter Parker very fully the major problems this new prospect presents to him and to us. I left him in no doubt that I look to him to do his utmost, faced with the harsh realities of their position in the market.

At my insistence, the Board have first taken a fresh and stringent look at their forecasts of their operating expenses and of their planned realisations. The Board's forecasts already incorporate economies in current costs approaching £100m. It would in my judgement be right in the circumstances to press them to work to an EFL requiring a further £40m operating economies next year and to go for a further £40m of realisations

CONFIDENTIAL

on top of the £25m already in their budget. This would require both a doubling of land sales and entire divestment of the hotels. I am proposing to examine whether realisations could be even more accelerated. I shall be having detailed discussions on this in the next two weeks. But I am bound to say that the prospects for imposing on the Board tougher objectives which would in fact be attainable seem remote.

On the pricing front, the Board face a very difficult market situation, made even more uncertain by the fact that their fares increase last November turned out in the event to be equivalent to a real increase of more than 5%. In these circumstances the Board have decided that the best course this year is to go for a general fares increase at the end of November which (on present forecasts) would be slightly under the rate of inflation. I am sure we cannot press them to go for a higher level. The only practical effect of this would be to load the burden more heavily onto the commuter, which is the only sector of the market which is not fully competitive.

To make a contribution to the remaining gap I have turned to investment, highly undesirable though it is to make reductions here. The Board are already proposing to hold investment next year down to the 85% level already authorised. I judge that it would be just tolerable to make a further reduction of £15m.

The economies I have set out above amount to £95m. on the Board's current forecast of an external financing requirement of £1113m. I believe that I could persuade Sir Peter Parker and his Board to accept the resulting EFL of £1018m. as realistic in the circumstances, provided that they were not expected to carry forward into 1982/83 any of the overshoot currently forecast for 1981-82. Am even tougher EFL would in my judgement not be regarded as realistic, and would lose the Board's full backing, which is essential. They would inevitably turn to closures of rural services and further fares increases, which would give us the most acute political difficulties without any major improvement in finances in the first year.

These figures assume that the Board's present assumptions on pay remain unchanged. They will lead to a gross pay-bill increase in the year of 7.75% of which 2.7% represents the flow-through effects of the settlement we accepted for this year, and of the 39-hour week agreed last year. The increase from changes in the year would then be about 5% (the actual changes in wage rates will of course be higher). Each reduction of 1% would save about £16m on the Board's costs, and I have therefore reviewed very fully with Sir Peter Parker his assessment of the pay situation next year to see if there is any saving to be made. The prospect is very difficult for him to foresee, since what he can achieve is much influenced by the course of other settlements earlier in the round. He will certainly go very hard for as low a settlement as possible. He has emphasised to me that the Board make very clear to the unions the constraints of the EFL and of the market situation. We could of course press them to assume a more modest increase, but I believe it would be simply wishful thinking to depart from their assumptions at this stage.

The prospects for the later years are very uncertain, and in my view we cannot at this stage put in any more than illustrative figures for 1983-84 and 1984-85. I propose that for these years we should simply increase the 1982-83 figure by the provisional inflation factors. This would after suitable rounding give £1080m in 1983-84 and £1150m in 1984-85 - reductions of £78m and £79m respectively on the latest forecasts set out in your paper. These figures would require sustained improvement in the performance of the railway, because it will not be practicable in future years either to continue to restrict investment in the renewal of the system to current levels or to rely on realisations as a source of finance.

CONFIDENTIAL

I am much concerned, as I know you are, at the unfavourable trend in the Board's finances, and their inability, even with great effort, to adapt quickly enough to changes in the market. The Board for their part are concerned about the rate of renewal of the equipment and the finance for that, in relation to the policy objectives set them, and had just asked Norman Fowler for a joint review. I am considering how best to set this up so that it can give me and the Board the full analysis which we need for sound prescriptions. I will let you know my proposals shortly.

I have of course considered whether there is any scope for finding greater savings from my other three industries to compensate for the shortfall on British Rail, but I have had to conclude that this is not a possibility. The savings I have offered for the other three industries in 1982/83 fall short by less than £3m of the total savings sought. The trading prospects for both BTDB and NBC have worsened substantially since they made their IFR submissions and the Board's management will be fully stretched to achieve the cuts I have proposed.

Copies of this letter go to the Prime Minister, the other members of E Committee, and to Sir Robert Armstrong.

Yours ever

David

DAVID HOWELL

CONFIDENTIAL