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From the Minister of State
for Industry and Information Technology

GEOFFREY PATTIE MP

NBPMW

Rt Hon Peter Rees QC MP
Chief Secretary to the Treasury
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

19 March 1985

Dear Peter

POSTAL BUSINESS TARGETS

As you will be aware, the current financial target and performance aim for the postal business expire at the end of this financial year and I have been considering replacement targets to run from 1985/86.

I am proposing that the time has now come to dispense with postal business targets and move to separate targets for each of Mails and Counters.

Profit

You discussed profit figures for the postal business with Norman Tebbit in the course of last year's IFR bilateral. Agreed numbers were subsequently published in the Public Expenditure White Paper. These represent a return, for EFL purposes, of 4.5% on turnover in each of the three years. In my letter of 25 February on Girobank targets, I argued that it would be unacceptable to set formal financial objectives which were inconsistent with the IFR numbers and that to do so would leave us vulnerable to criticism from the PAC. The same point applies to these targets.

We are in fact also vulnerable to criticism because the postal business profit target is much too high and is now wholly unrelated to the principles set out in Cmnd 7131. 4.5% on turnover represents some 8-10% return on capital employed and is around twice as high as would be suggested by the application of the required rate of return approach advocated in the 1978 White Paper. There are therefore strong resource allocation arguments in favour of a much lower target.

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The precise quantification of the appropriate profit target can only be determined after detailed study which will require major inputs from our economic advisers. I would therefore propose that our officials should begin such a study immediately, in consultation with the Post Office, with a view to reporting to us by, say, the end of June. This would enable a considered view to be taken in time to use appropriate numbers in this year's IFR. In the meantime, I would propose to set a formal financial objective of 4.5% on turnover for each of Mails and Counters for each of the next three years. This will continue to be on a current cost basis and will be pre-tax and after interest.

Performance Aim

Our officials held discussions with the Post Office last year on the scope for efficiency improvement and, following further consultation with the Post Office, I have concluded that it would be right to set a target for a reduction in real unit costs of 7½% over the next three years for Mails and 6½% for Counters. My officials have sent yours a detailed note setting out the key assumptions behind this conclusion.

The Post Office has suggested that there are advantages in retaining the 1981/82 base for the new target and I am persuaded that this would be sensible. It aids simplicity. The alternative base year, 1984/85, is exceptional for three reasons. For Post Office accounting purposes, it is a 53-week year; Mails figures are inflated by the European Elections and Counters figures are heavily distorted as a result of the DHSS dispute. Adjustments would be necessary to the base numbers to provide a more realistic assessment of performance and this would lose some of the benefits of simplicity. I have it in mind to use the accounts directions to require a reconciliation of RUC performance to the published accounts for 1985/86 onwards (this is being done for 1985/86 for profit and EFL) and again, simplicity is a key objective and is aided by a 1981/82 base.

The latest forecast for RUC outturn for the three years to 1984/85 (after eliminating the special factors mentioned above) is 6% for Mails and 3.5% for Counters. Compounding the improvement over the past three years by the targets which I am suggesting for the next three years produces figures of 13.1% for Mails and 9.6% for Counters on a 1981/82 base. I am therefore proposing to set a new target for the Mails business to reduce real unit costs by 13% in the six years to 1987/88, and for a reduction in Counters' real unit costs of 10% over the same period.

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Annual Sub-targets

I regard it as important that we should expect some minimum improvement each year. However, it is an accepted White Paper principle that targets should be medium-term to allow the business to plan ahead and to allow for schemes where costs might be incurred early in the target period which bring benefits by the end of the period. I am therefore intending to specify a minimum of 1.5% RUC improvement in any one year.

In conclusion, I would say that I believe that the proposed RUC targets are very stretching. Performance against the present target has been aided by the benefit of successive national insurance surcharge reductions worth nearly 2% to the postal business RUC. I am therefore proposing significantly higher targets over the next three years. These include assumptions on pay settlements and productivity improvements that will see unit labour costs falling by 7-8% in real terms for the Mails business and by 4-5% for Counters. I believe that we must maintain the pressure for substantial efficiency improvements within the businesses including the major issues discussed at the recent UCW conference and including the continued critical look at the Counters network. The targets are, I believe, set at a level that depends on a large number of necessary measures being implemented and there is a risk that the targets might not be met - particularly if there is continued obstruction from the Post Office unions. But clearly we should not set targets that legitimise union resistance to improved efficiency. I hope that you agree to my proposals and that you will indicate this in time for an announcement this month - to avoid the embarrassment of announcing targets once the target period has begun.

I am copying this letter to the Prime Minister, other members of E(NI) and Sir Robert Armstrong.

John
Pattie

GEOFFREY PATTIE

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Treasury Chambers, Parliament Street, SW1P 3AG

Geoffrey Pattie MP
 Minister of State for Industry and
 Information Technology
 Department of Trade and Industry
 1 - 19 Victoria Street
 London SW1

17 April 1985

Dear Minister

POST OFFICE: TARGETS

Thank you for your letter of 19 March about PO targets. I agree with many of your proposals but also have a few reservations which I discuss below.

I support your intention to discontinue postal business targets and instead to publish separate financial and efficiency targets for Mails and Counters. I think there would be still further advantages if separate targets were combined with separate EFLs for the constituent businesses. Unless you can see any major objection I suggest that we proceed this way in this year's IFR.

Profit Target

I am content to go along with the level of profit target you propose for each of the next 3 years. You also suggest a review of this target. I do not necessarily disagree with your argument that the levels of profit consistent with the targets you will now be announcing may be difficult to reconcile with some of the principles in Cmnd 7131. I am broadly content for our officials to look at these issues but I have some observations and suggestions.

An immediate review could raise awkward issues of presentation. The profit target is intended to set a medium term planning framework. It would be seen as inconsistent with this intention and unco-ordinated to review the target with the objective of adjusting its level so early on in a new target period. These problems could be compounded because an adjustment to the profit target could have major consequences for the assumptions about volume growth behind the RUC target. That target too would need to be reviewed

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and possibly adjusted simultaneously.

This awkwardness arises because your target proposals have been made so close to the end of the target period. The new targets should now be announced but before we proceed with a review I should be interested in your proposals for managing these timing and presentational problems.

There could also be major public expenditure implications to your proposal. A level of profits consistent with Cmnd 7131 could lead indirectly to a significant and continuing increase in the Post Office's external financing requirements unless compensating adjustments, such as a substantial reduction in capital spending or an increased level of asset disposals, could be secured. It would be extremely difficult to accommodate substantially increased financing requirements with the current and prospective pressures on public expenditure totals. The review should consider how to reconcile the EFLs which we have agreed with the reduced profit target which you are advocating.

Finally, officials are due to consider during the summer the prospects for introducing private capital into the Post Office and the scope for an consequences of relaxing the postal monopoly. I should like your assurance that any review of the profit target will not impede or delay either these reviews or officials' consideration of the Post Office's Corporate Plan which is now due.

Performance Target

Your proposals for RUC reductions over the next three years are less demanding than the figures I mentioned to Norman Tebbit in last year's IFR. However, the differences are small and on the basis of your view that these targets are challenging and very stretching and, subject to the points below, I am prepared not to press you to seek still more demanding efficiency gains.

My first point concerns the annual sub targets. The overall targets are slightly less rigorous than I had originally hoped for and I consequently regard it as all the more important that the Post Office are given every encouragement to achieve them. The sub targets you propose allow Mails to postpone a significant proportion of the necessary efficiency savings until the final year of the target period. Requiring Mails to start delivering proportionately greater efficiency gains from the outset would reduce the risk which is inherent in your proposals of a last minute failure against the target. I suggest that the minimum annual sub target for Mails is increased to two per cent.

Secondly I am not convinced by your argument about rebasing the targets back to 1981-82. We are entering a new target period and in logic there is no reason to link this period back to an expired period. Moreover I

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see positive benefits in using the end of the expiring target period as the base. It avoids the need to incorporate in the calculations precise forecasts about outturn against the present targets and is consequently more certain. Nor am I convinced that there is ever a year which is not somewhat affected by one-off extraneous factors. For these reasons I hope you will agree to set 1984-85 as the base year without adjustment.

We should obviously aim to agree and announce these targets as soon as possible after they were due to come into effect. It is disappointing that you were only able to make proposals to me so near the end of the current target period and I hope you will not have any difficulties with the suggestions I have made.

I am copying this letter to the Prime Minister, E(NI) and Sir Robert Armstrong.

Yours sincerely

P. Rees

for PETER REES

[Approved by the Chief Secretary]

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From the Minister of State
for Industry and Information Technology

GEOFFREY PATTIE MP

Rt Hon Peter Rees QC MP
Chief Secretary to the
Treasury
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

30 April 1985

Dear Chief Secretary,

POST OFFICE TARGETS

Thank you for your letter of 17 April from which I was glad to learn of your agreement to a review of the appropriate profit targets for the Mails and Counters businesses of the Post Office. Before I announce the review, however, I think that it is necessary to be clearer on one or two points.

I cannot agree to your suggestion that "the review should consider how to reconcile the EFLs which we have agreed with the reduced profit target" which I am advocating. For a start, we have not agreed EFLs for the period to which the review will relate - 1986/87 onwards. We have agreed planning totals for the first two years. But more importantly, there already exists a review procedure for considering precisely this issue - the Investment and Financing Review. The proposal in my letter of 19 March was that the IFR should be preceded by a review of the profit targets that would cover the basis on which the targets are set and their quantification. This should be completed in time to allow the properly-determined numbers to be fed into the Post Office bid and we would then be in a position to consider what further savings might be necessary in the context of your public expenditure survey exercise.

I do believe that, unless you can agree to this change of emphasis, we shall be left in a wholly indefensible position on Post Office targets. In our dealings with the Post Office and publicly we shall be stressing the merits of Government policy towards nationalised industries as set out in Cmnd 7131; we shall continue to argue, as the MMC did in its recent report, that it is essential

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that the Post Office should develop a model of long-run marginal costs; we shall argue on investment appraisal cases that the opportunity cost of capital must be recognised by the RRR approach; and, on the basis of your suggestion, we shall continue to insist that these two factors and general resource allocation arguments have no place in determining Post Office profits or the price of a postage stamp.

As you have acknowledged in your letter, the present profit targets are substantially higher than can be justified on the basis of Cmnd 7131. A return to rational targets has significant implications for prices. There is no case, in my view, for an increase in the inland letters tariff in 1985/86 and, on present inflation assumptions and given the demanding efficiency targets for Mails on which we are agreed, a move to the basis of target setting that I am proposing would mean that inland letter prices could be maintained for a considerable period. There is a real prospect of a 3½ year freeze on inland letter tariffs. Such an outcome would have clear benefits for counter-inflation policy.

I accept your point that it is presentationally difficult to announce simultaneously three-year profit targets and an immediate review of those targets - although I feel that you may be over-estimating the importance of the profit target in the Post Office's medium-term planning. The very good performance in the last two years, which were subject to annual profit targets but a three year RUC target, illustrates well it is the RUC target that is the main driving force for the Post Office. With this in mind, I have consulted the Post Office and confirmed that the Chairman is content for me to announce that we shall be conducting a review of the appropriate profit targets now that we are treating Mails and Counters as separate businesses from 1986/87 and that, as an interim measure, we shall be setting a one year profit target for 1985/86. The fact that we are now some way into the target period reinforces the case for this approach. As the Post office is content, I assume that you have no objections.

There is one other point on which I should be grateful if you would reconsider your position. This concerns your rejection of my proposal to use 1981/82 as the base year for the RUC targets. I could not in any case agree to set 1984/85 as the base year "without adjustment". It is quite likely that 1984/85 will include some £24 million of Counters closures costs which would yield a Counters RUC benefit of 3% simply by not being repeated in 1985/86; and 1984/85 may well include up to £30 million lead-in payments in connection with the productivity package being negotiated on the Mails side - with an immediate 1¼% Mails RUC benefit in 1985/86.

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Your proposal for separate EFLs for Mails and Counters for 1986/87 raises a number of practical difficulties in that useable data will not be available until after the start of the 1986/87 accounting period. I can agree to increase the annual minimum RUC increase for Mails to 2%; and I can assure you that officials here will be able to cope with the review of the profit target in addition to the other work which you mention in your letter.

Finally, I would add that I share your concern about the delay in agreeing and announcing these targets and I therefore hope that you will be able to let me know fairly quickly that you are content for me to announce the review and the new targets through an arranged PQ. A draft of the proposed announcement is attached.

I am copying this letter to the Prime Minister, members of E(NI) and Sir Robert Armstrong.

Yours sincerely,

Timothy Abraham

pp. GEOFFREY PATTIE

*(Approved by the Minister
and signed in his absence)*

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DRAFT PARLIAMENTARY QUESTION AND ANSWER

Q. To ask the Secretary of State for Trade and Industry if he will announce financial objectives and performance aims for the postal business of the Post Office; and if he will make a statement.

A. Over the last several months the Post Office has moved to greater separation of the Mails and Counters businesses operationally, managerially and financially. I have therefore decided that this is the right time to discontinue the setting of postal business targets and to move, from 1985/86, to setting targets separately for each of Royal Mail and Counters. National Girobank is already targeted separately.

The postal business was set the performance aim in February 1982 of reducing its real unit costs by 5% in the three years to 1984/85 taking 1981/82 as a base, with a provision for a reduction of 2% in 1982/83. I congratulate the management and workforce of the Post Office for having bettered that target on the basis of latest estimates. Within that figure, the contribution of the Royal Mails business was somewhat greater - at an estimated 6% reduction - than that of the Counters business - an estimated 3½%.

I have decided that the Royal Mails business should be set the target of further reducing its real unit costs over the three years to 1987/88 to secure a total reduction of 13% compared with 1981/82; and that the Counters business should be targeted for a total reduction of 10% compared with 1981/82. This equates to a 7.5% reduction over the next three years for Royal Mails and a 6.5% reduction for Counters. I have also decided that Mails should be targeted for a minimum annual reduction of 2% and Counters 1.5%.

The Government have no doubt that it is vital to the future of both businesses and to the future of jobs in both businesses that the Post Office should strive to make significant improvements in efficiency in order to retain its existing customers and to attract new work. I believe that these targets are demanding but I am confident that the Post Office is capable of reaching them.

The move to separate targets raises certain problems in attempting to set financial objectives. It will be a little time yet before sufficiently robust figures are available on which separate profit targets for the two businesses could be determined.

I have therefore decided to review the financial objectives for Mails and Counters and to delay setting medium-term financial objectives until later this year. As an interim measure therefore, I have decided that each of Royal Mails and Counters businesses should be required to secure a 4.5% return on turnover, on the current cost accounting convention, before tax but after interest, for the financial year 1985/86.

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Treasury Chambers, Parliament Street, SW1P 3AG

Geoffrey Pattie Esq MP
Minister of State for Industry
and Information Technology
Department of Trade and Industry
1 - 19 Victoria Street
London
SW1

14 May 1985

Alan Gregory

POST OFFICE: TARGETS

Thank you for your letter of 30 April.

I have some comments which I should like to make on your latest suggestions about the review of the Post Office profit targets which you first proposed in your letter of 19 March. I agreed to your proposal in my letter of 17 April but also suggested that the review should take into account the effects of an adjusted profit target on the agreed baselines. You suggested some difficulties with this approach.

Nevertheless in present circumstances I think it would be irresponsible for the review not to consider the public expenditure implications of changes to the three year profit target which you proposed in your 19 March letter, and ways in which any increases in the Post Office's future external financing requirements could be accommodated and offset. I have seen the Post Office's bids for substantial increases over baseline in each of the years covered by the current IFR. These bids purport to reflect a change in the profit target to a 3 per cent return on capital. The reasons for this change are opaque but I assume it is an attempt to prejudge the outcome of the proposed review. The size of the Post Office's extra bids in this year's IFR has reinforced my view that the review you have proposed would be a major risk to public expenditure baselines without the conditions I have suggested.

I also have some further suggestions about your latest proposals for managing the timing and presentational difficulties of a review. I argued in my letter of 17 April that the profit targets and the efficiency targets are connected. Changes in the profit targets can be expected to influence the volume of Mails and Counters business and so impact on the assumptions underlying the efficiency targets. If the profit targets are

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to be reviewed this connection means that the efficiency targets should be reviewed simultaneously and possibly adjusted to ensure that they continue to require the same demanding standards of performance which you had originally envisaged. It follows that if we are to set one year interim profit targets as you suggest we should also be setting one year efficiency targets so that the results of the review can be taken into account in formulating both sets of follow-on targets.

You have already proposed that Mails and Counters should each be targeted to achieve 4.5 per cent turnover 1985-86 and we have also agreed that Mails should be expected to achieve at least a 2 per cent reduction in real unit costs this year and Counters at least 1.5 per cent. I suggest that we now set these one year targets and officials start the review of the financial target and aim to report back to us by the end of August. The review by officials should cover the present formulation and level of the Post Office's financial target and should consider all relevant factors, including:

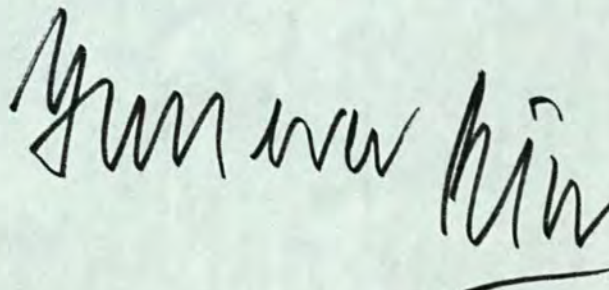
- (i) the consistency of the present financial targets with Government policies and objectives;
- (ii) the implications of the principles in Command 7131 for the particular circumstances of the Post Office;
- (iii) the consequences of any revisions to the financial targets for the Post Office's efficiency targets, EFL baselines and public expenditure

I note your comments about the need for adjustments in using 1984-85 as the base year for the new targets but in the absence of any arguments about principle I suggest that we take 1984-85 as the base year and our officials examine the implications for the targets of the adjustments you mention.

On my proposal for separate EFLs for Mails and Counters, you suggest there are practical difficulties. I accept that it would be unrealistic to expect a system of separate EFLs to operate with perfect precision from the outset. On that basis, I suggest our officials examine the practical difficulties you mention and aim to resolve them in time for final decisions in the IFR.

I hope officials can now proceed on the basis outlined above.

I am copying this letter to the Prime Minister, members of E(NI) and Sir Robert Armstrong.



PETER REES

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