The East Coast franchise debacle: only the latest problem arising from rail privatisation

Robert Jupe provides a history of the East Coast Main Line franchise and examines its latest problems. He concludes that the current debacle illustrates how privatisation, far from improving efficiency, has fragmented an integrated industry into many constituent parts, and an alternative approach is now necessary.

The Conservative Government announced on 16 May that the East Coast franchise will be temporarily renationalised, after its operators could no longer meet the payments promised in their contract. Franchise bidding was a key element of rail privatisation introduced by the Major Government in the 1990s. It was intended to improve services, and reduce subsidy, by attracting new entrants into the rail industry. Bidders are required to offer premium payments to government on the profitable franchise routes, or to bid to operate at minimum subsidy on the loss-making routes.

In practice, there are only a small number of bidders for each franchise, and there have been frequent problems with operators winning franchises on the basis of overoptimistic bids. This has now happened three times on the East Coast Main Line franchise.

Originally, the franchise was awarded to GNER in 2005 after it agreed to a premium payment of £1.3 billion over 10 years, assuming annual revenue increases of 9%. It abandoned the contract, however, when passenger numbers failed to materialise, and its parent, Sea Containers, faced bankruptcy. The replacement operator, National Express, contracted in 2007 to pay an even higher premium of £1.4 billion over seven years. But in 2009, the company was faced with a revenue growth of only 0.3% in the first quarter of the year, and with the need to renegotiate terms on its £1.2 billion debt.

After National Express abandoned the contract, the franchise was renationalised in 2009 by the Labour Government which established Directly Operated Railways to manage the line under public ownership. Despite infrastructure problems, there were improved levels of customer satisfaction and punctuality. Further, the state-owned operator, which did not have to pay dividends to shareholders, was more financially successful than its private sector counterparts – before or since – and managed to return £1 billion in premium payments to the government.

Despite its successful operation under public ownership, the East Coast franchise was re-privatised by the Conservative-led Coalition Government on ideological grounds in 2015 on the eve of the general election. Its new operators, Stagecoach and Virgin, with operating company shares of 90% and 10% respectively, bid £3.3 billion for an eight-year franchise, far more than in the previous two failed bids. The predicted revenue growth again failed to materialise, however, and after Stagecoach had lost around £200 million of its own funds and breached a financial covenant, Transport Secretary Chris Grayling renationalised the franchise until 2020. Ending the franchise will allow the operators to avoid around £2 billion in payments up to 2023, and they will further benefit by not suffering any penalties in future bidding competitions for rail franchises. By 2020, the franchise is meant to be converted into a public-private partnership, but details of how this would operate are not yet clear.

The East Coast franchise debacle is only the latest in the many problems arising from rail privatisation. With rail privatisation, it was argued that the introduction of competition and private sector management would, in the long run, improve efficiency, reduce costs, eliminate subsidy, reduce the need for government intervention and provide better services for passengers. In practice, rail costs have doubled in real terms under privatisation, the current rail subsidy of £4 billion (net of premium payments) is several times the annual subsidy received by the much-maligned British Rail in the years before privatisation, and passengers in franchises such as Southern have suffered from many delays and disruptions.

Although still subject to jibes about its sandwiches, British Rail in the decade before privatisation undertook a long and painful business-focused reorganisation which left it one of the most efficient railways in Europe. Ironically, this reorganisation was only completed in 1992, the year the Conservative Government's rail privatisation proposals were published.

Privatisation, far from improving efficiency, fragmented an integrated industry into many constituent parts: an infrastructure provider (now Network Rail, which is in the public sector and replaced the failed Railtrack); franchised train operating companies; and rolling stock companies which lease trains to the operating companies.

A key reason for franchising is the continuing attempt by government to obtain high premium payments from operators on the most profitable routes, meaning that there is an ongoing problem of overoptimistic bidding and passengers are faced with significant annual fare increases. Hence, the feature of ebullient bidding is not confined to the East Coast franchise. For example, currently two other operators, Greater Anglia and Transpenine Express, are said by financial analysts to be facing problems because of optimistic forecasts. The rail franchising sector was supposed to unleash the benefits of competition and private enterprise, but it is now dominated by subsidiaries of three state-owned railways – those of France, Germany and the Netherlands – which benefit from British government subsidy.

The fundamental problem with financing rail is that, as a highly capital-intensive industry, it is very difficult to cover the costs of both the infrastructure and train operations from fares. This dilemma has been critical for rail under both private and public ownership. British Rail came closest to resolving the dilemma before its privatisation by undertaking major organisational reforms which resulted in very significant improvements in productivity and punctuality.

An alternative approach to the privatisation model would be to bring franchises back into the public sector at no cost as they expire, or as operators run into financial difficulty or contract breaches, and merge them with Network Rail. The industry could then be gradually reintegrated, and substantial savings made as dividends would not be paid to shareholders and the costs relating to fragmentation would be reduced. Further, responsibility for rail could be transferred from the Department for Transport to the new, publicly-owned rail body. The ultimate paradox of the flawed privatisation of rail is that it has led, because of all the problems which have arisen, to far more State intervention in rail than when British Rail was responsible for operating the whole railway.

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Note: the above draws on the author's published research (with Warwick Funnell) in *Business History*.

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