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RAIL PRIVATISATION - HOW IS IT GOING?

C.A. NASH

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1. INTRODUCTION

The 1993 Railways Act provided for the privatisation of British Rail in the form of franchising of passenger services and outright sale of all other parts of the business. The privatisation was unusually complex, with the existing single organisation being divided into more than 80 separate companies, the intention being to create competition not just in the form of competing train operating companies, but also for the supply of services such as rolling stock and track maintenance, wherever possible. The aim of this paper is to review events since the process of rail privatisation in Britain really started in April 1994. It is based partly on the publications of the relevant bodies and the technical press but partly on conversations with those in the industry. It is divided into five sections, looking in turn at Railtrack and the ROSCOs, the passenger franchising process, the freight sector and other businesses before seeking to draw some overall conclusions.

2. RAILTRACK AND THE ROLLING STOCK LEASING COMPANIES

As from April 1 1994, the rail industry was substantially reorganised ready for privatisation. In particular, Railtrack was set up as a separate publicly owned company to own and manage the infrastructure and sell access to it to train operating companies. Initial track access charges for passenger operators were determined by the Department of Transport on the basis of recovering all costs including replacement of assets and a rate of return of 5.6% on the modern equivalent value of the asset base, to be gradually raised to 8% (Nash.1996). Charges took the form of a high fixed charge, plus a low variable charge per train kilometre, varying with the type of stock, the latter simply designed to recover wear and tear costs (and the cost of electricity where electric traction is used). Freight charges were to be negotiated on a flow by flow basis according to what the traffic could bear, as would charges for new open access operators and for changes in the access arrangements for existing operators. A new body, the Office of the Rail Regulator, was set up with various responsibilities including regulating track access charges, and in his first review, the Rail Regulator determined that the track access charges for passenger services were higher than was necessary for Railtrack to meet its commitments and should be reduced by 8% immediately, and by a further 2% per annum up to the year 2000. (ORR, 1995). In May 1996, Railtrack was privatised by the sale of shares, raising a total of nearly £2b.

At the time Railtrack was set up, many of the Train Operating Companies reported considerable concern about the loss of control over key assets which determine their quality of service. However, as part of the subsequently negotiated track access agreements, a performance regime was included under which Railtrack has to compensate Train Operating Companies for delays or cancellations which are its responsibility and vice versa. Thus Railtrack has a very direct commercial interest in ensuring a high standard of performance. It is reported that punctuality and reliability have generally improved under the new regime (see for instance, Pegasus, Dec. 1996, p.1) which seems to be working well. However, operators continue to complain about slowness in negotiating changes to access arrangements, and - partly to speed up the consideration of new flows of traffic - the new freight operator is understood to be seeking to put its charges on the basis of a two part tariff similar to that faced by passenger operators, rather than the existing flow by flow basis.

More concern has been expressed about the level of investment. The Regulator determined charges at a level which should permit the renewal of assets so as to at least ensure the continuation of rail services at current levels and qualities. However, he has expressed concern that investment is not taking place at the necessary rate. The pressure on Railtrack to renew its assets comes from the fact that otherwise in the longer term its performance will deteriorate, triggering penalty payments.

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Doubts have been expressed about whether this is an adequate incentive, and the Regulator has threatened further action if he is not satisfied with Railtrack's performance in this respect.

At the same time as Railtrack was set up, the passenger rolling stock was placed into three new companies (the ROSCOs), and leasing agreements were set up between these and the various Train Operating Companies, which were at the time still within British Rail. These were based on charges which again included depreciation at replacement cost and interest, but with an offsetting reduction in the case of older stock on acount of its higher operating and maintenance costs. These companies were privatised by outright sale, in two cases to Management Buyouts and in one case to an internationl financial consortium, raising a total of some £1.8b. Both management buyouts have since been taken over at substantially increased prices, in one case by Stagecoach, which is also a train operator, raising issues for competition policy as the company concerned leases rolling stock to Stagecoach's rival train operators. The takeover was permitted to proceed on condition that the ROSCO continued to be managed as a separate company and did not favour Stagecoach over other operators in its leasing terms.

3. FRANCHISING

Rail passenger services were reorganised into 25 Train Operating Companies to be franchised out to the private sector. Responsibility for the franchising process rests with another new body - the Office of Passenger Rail Franchising (OPRAF), which sets minimum service standards (the Passenger Service Requirement) in terms of frequency, speed, and in some cases other criteria such as reliability and crowding, as well as controlling certain fares. OPRAF then invites bids in terms of the subsidy per annum that operators will require to run the services, usually on the basis of a 7 year franchise, but with the option of a longer franchise incorporating specific investments.

Generally the Passenger Service Requirement stipulated services close to current levels for unprofitable services, but gave more freedom to operators where services were closer to commercial viability. In the case of London commuter services the emphasis was on the level of capacity provided during the peak. OPRAF has a duty to develop systematic criteria for taking decisions on support, and late in 1996 it published a consultation document suggesting that these should be based on a form of cost-benefit analysis, although ignoring user benefits when it was felt that these could be captured by the operator as revenue, and looking more broadly at environmental and economic implications of major projects (OPRAF, 1996). Clearly there was not time to develop these criteria in the first round of franchising, and therefore franchises for up to 15 years have been entered into more on the basis of preserving something close to the status quo than on the optimal use of support. Perhaps this was politically inevitable anyway, regardless of time contraints.

The franchising process started with Great Western and South West Trains, which started operation in February 1996 and was completed early in 1997. It is thought that the franchise was almost always awarded to the lowest credible bid; the successful franchisees and their bids are shown in Table 1. Whilst the first two bids promised relatively low rates of reduction of subsidy, bids have become progressively more optimistic, culminating in the biggest and most complex franchise, Inter City West Coast, which was won by Virgin, promising to turn a £77m subsidy in the first year into a £220m premium payment to OPRAF in the last year of a 15 year franchise. Whilst the more ambitious bids clearly rely heavily on generating substantial increases in passenger revenue, it appears that also substantial cost reductions are anticipated and a start has already been made. For instance, several operators report a reduction in the number of drivers of the order of 30%, resulting from measures such as greater flexibility in shift length and an ending of the requirement that trains travelling at more than 110m.p.h. have two drivers in the cab.

Although a relatively small number of organisations were involved in bidding, the bidding appears to have been very competitive, with several serious bids for each franchise. The nature of the winning organisations is summarised in Table 2. It is seen that the bus industry dominates the scene, with a small number of successful management buyouts, a French conglomerate, Virgin, Sea Containers and a consultancy led company the other players. The dominance of the bus industry has raised concerns about lack of competition where the franchisee is also the major bus operator in the district. One case, the takeover of the Midland Main Line by National Express, which also operates almost all the express coach services from the area in question, has been referred to the Monopolies and Mergers Commission, but National Express was permitted to retain both sets of services on giving various undertakings about the future price and frequency of express coach services on the routes in question (MMC, 1996).

Assuming a linear rate of decline of subsidy, over the first 7 years of subsidy the annual demands on the exchequer should be reduced by some £1,000m (Table 3). However, it is worth remembering that the new basis of charging for the use of infrastructure and operations led to the subsidy bill rising from £1.1b in 1993/4 to £2b in 1994/5 (Table 4). It will thus be several years before subsidies return to the level they were at before the process started in 1993/4. In addition, there have been major transition costs, and the operating costs of OPRAF and ORR must be taken into account. On the other hand, the taxpayer has benefitted from the proceeds of the sale of Railtrack, the ROSCO's and the other constituent parts of BR (maybe some £4.3b, but the costs of the privatisation process of at least £0.25b must be deducted from that - see Modern Railways Informed Sources, January 1997) and the payments should provide for a higher level of investment than has been the case in the past. It thus appears that, unless a high rate of subsidy reduction could have been achieved by British Rail without privatisation (and the performance of BR in the favourable economic climate of the 1980’s when it halved subsidy in real terms, should not be forgotten - see Nash and Preston, 1992), the net outcome should not be the sort of big increase in costs that was initially feared, and may even be beneficial for the taxpayer, although not nearly as much so as implied by a simple examination of the trends in support in the franchise agreements. This also presupposes that these reductions in support are actually achieved (see section 5). Some commentators include writing off of debt as part of the cost of privatisation, but we are only interested in the net effect on cash flows, and it is unlikely that interest on debt would have exceeded future borrowings.

Whilst there was a virtual halt to new projects, particularly rolling stock replacement, whilst the privatisation process was underway, many of the franchise agreements do provide for substantial investment. These include substantial amounts of new rolling stock on the London Tilbury and Southend Line, South East Trains and Cross Country, and tilting trains for the West Coast Main Line, in conjunction with substantial renewal and upgrading by Railtrack. Elsewhere, innovative service patterns and higher frequencies have been offered, including the provision of a semifast service on the Midland Main line which will virtually double the number of train miles run. Again it should be remembered that British Rail itself had a record of introducing innovatory new and improved services particularly in the late 1980s so it should not be assumed that none of these innovations would have happened without privatisation. Moreover there are some developments which disadvantage passengers, such as more restrictions on the availability of fares by alternative routes, fewer cases of holding of connections (of course this actually benefits some passengers) and problems with the provision of passenger information (see section 5). Overall, however, it seems unlikely that passengers will be seriously disadvantaged by the changes if franchisees fulfil the conditions of their franchise agreements.

4. FREIGHT

In the freight sector, it was intended to create a competitive market within the rail mode. To this end the former BR Trainload freight sector was divided into three separate companies, and these, Rail

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Exress Systems (the post and charter train operator) Railfreight Distribution (the operator of services to the continent of Europe via the Channel Tunnel) and Freightliner (operator of container services, principally to deep-sea ports) were all offered for sale separately. In addition open access was provided for any other operator who wished to run services, including existing freight customers who might wish to run their own trains.

In the event all the BR freight businesses except Freightliner (which was bought by a Management Buyout) were obtained by the same company, English, Welsh and Scottish Railways (EWS), which is owned by a consortium led by a small US railroad, Wisconsin Central. Whilst two freight customers (National Power and British Nuclear Fuels) are running their own trains, there is little sign of any other entry into the market. It appears that there are still substantial barriers to entry in the form of the need to obtain a safety case, negotiate access arrangements with Railtrack and obtain staff with the necessary skills and knowledge (including drivers with the route knowledge to run the services proposed). Thus rail freight remains almost a monopoly. Arguably however this is a desirable outcome; EWS claim that there are considerable economies of scale in terms of reduced overheads, better utilisation of assets etc from having a single company and give the scale and geographical spread of the companies this seems plausible. Competition from road haulage is sufficient to provide market discipline in most segments of the market. (Elsewhere, as for coal, the presence of customers large enough to run their own services if need be is another effective source of countervailing power, and rates for such traffic are believed to have fallen sharply). Certainly English Welsh and Scottish Railways have made a determined start on reducing costs and increasing traffic, and have set themselves the remarkable target of trebling rail freight tonne kilometres over 10 years. They have also begun reinvestment, with a substantial order for 250 locomotives.

4. OTHER BUSINESSES

In addition to the three main business sectors described above, the privatisation has taken place of many other companies formed from parts of British Rail. Foremost amongst these are the infrastructure maintenance and renewal companies and the rolling stock heavy maintenance companies. These were sold to a mixture of existing engineering firms and management buyouts. Amongst the other companies privatised are included BR Business Systems, (responsible for computer and ticket issuing systems), BR Research, Rail Operational Research, engineering design offices, marketing organisations and many others.

5. ASSESSMENT

It appears from the above that the privatisation process has been completed remarkably smoothly, in an extraordinarily short period of time. In part this has been the result of a pragmatic approach to actual implementation which has seen many departures from original intentions - for instance, OPRAF has been willing to award longer franchises in return for promises of investment, open access has been limited, at least until 2001, and the freight monopoly outcome has already been commented upon. There are certainly areas which remain of concern. For instance, surveys undertaken by the Consumers Association has found that the quality and impartiality of information on fares and services has been poor. Whilst many of their examples are extreme cases where cheaper fares available on very limited and unattractive services have not been mentioned, some are not, and the Regulator clearly perceives there to be a problem (ORR, 1997). Another concern surrounds the inability of one of the first franchisees - South West Trains - to fulfil its Passenger Service Requirement regarding levels of service following a too rapid reduction in the number of drivers. An emergency timetable, cancelling many services, has been introduced. Of course, Stagecoach will pay penalties to OPRAF for failing to fulfil the terms of its franchising agreement, but this early example of a new operator appearing to place cost cutting above its duty to provide services has renewed fears that service levels may suffer as a result of privatisation.

Looking ahead, there remain potential problems. One surrounds the intention of the Regulator progressively to move towards open access for passenger operators (with the exception of Inter City West Coast services, where in return for the high level of investment required, protection from competition will continue throughout the 15 year franchise). Other work we have undertaken suggests that, whilst head on competition will tend to be unprofitable for the entrant, cream skimming entry with a few key trains may be profitable, and reduce the profits of the incumbent even if they are successful in retaliation. Scope for this may be limited by lack of track capacity unless incumbents are forced to surrender paths, however, as obviously cream skimmers would be looking for peak hour paths into the main termini. The most likely entrants of this type would be neighbouring franchisees.

It can be seen from Table 3 that several franchisees are committed to a 7 year subsidy reduction which is more than 50% of current turnover. For some, this will rest heavily on cost reductions but others are projecting big increases in revenue. This raises the more general issue of what will happen if the franchisees are unable to secure the ambitious targets in terms of revenue increases on the basis of which many of them have made their bids. Apart from increased competition, the most likely cause of this is a downturn in the economy. In this situation, they have the right to reopen negotiations with OPRAF on the terms of their franchise, and if the problem is genuinely due to circumstances outside their own control, it appears likely that OPRAF will agree to some combination of cuts in services and increased subsidy. Should a franchisee become insolvent, then OPRAF would also obviously have to secure a replacement operator, and again the cost of this might be increased subsidies, poorer services or both. The cost and difficulty of this might well incline OPRAF to renogotiate subsidies and service levels rather then face this situation. Many sources in the industry believe that bidders assumed this to be the case in making such favourable bids. If they are only able to secure this performance in the face of favourable economic circumstances, then this reinforces the point that the achievement of British Rail in the favourable economic climate of the second half of the 1980's, where it halved subsidies whilst expanding traffic, should also not be forgotten. It is quite possible that a major reduction in subsidy with improved services could have been achieved without privatisation.

Thus there remain uncertainties ahead and it is by no means clear that the outcome will necessarily be more favourable than it would have been under the old regime. However, few observors would have imagined at the start of the process that it would be possible virtually to complete such a complicated privatisation process within the space of three years. If franchisees are indeed able to fulfil the terms of their franchise agreement whilst at the same time operating at a profit, prospects for the railway industry look good. Only time will tell if this is indeed the case.

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Table 1: Rail Franchises

Franchise	Franchise	Length of Franchise (yrs)	Subsidy (£m) First Year	Subsidy (£m) Last Year
Great Western	MBO	10	59.9	31.6
South West Trains	Stagecoach	7	60.1	40.3
InterCity East Coast	Sea Containers	7	64.6	0
Midland Main Line	National Express	10	16.5	-10.0
Gatwick Express	National Express	15	-4.6	-22.6
LTS Rail	Prism	15	29.5	11.2
South Central	Connex	7	85.3	34.6
Chiltern Railways	MBO	7	16.5	2.9
South East Trains	Connex	15	125.4	-2.8
South Wales & West	Prism	7½	70.9	38.1
Cardiff Railways	Prism	7½	19.9	13.3
Thames Trains	MBO	7½	33.2	0
Island Railways	Stagecoach	5	2.0	1.75
Regional Railways North West	G&W Holdings	10	191.9	125.5
Regional Railways North East	MTL	7	223.2	145.6
North London Railways	NEG	7½	54.8	16.9
Thameslink	GOVIA	7 yrs 1 mth	-2.5	-28.4
ICWC	Virgin	15	76.8	-220.3
Scotrail	NEG	7	280.1	202.5
Central	NEG	7	198.1	132.6
Cross Country	Virgin	15	112.9	-10
Anglia	GB Railways	7 yrs 3 mths	35.9	6.3
Great Eastern	First Bus	7 yrs 3 mths	29	-9.5
West Anglia Great Northern	PRISM	7 yrs 3 mths	52.9	-24.8
Merseyrail	MTL	7	80.7	60.0

Source: Local Transport Today 13/3/97

Note: Negative Subsidies indicate payment of a premium.

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Table 2: Franchisees

Franchisees	No. of Franchises
National Express	5
Prism	4
Virgin	2
Gt Western Holdings	2
Connex	2
MTL	2
Stagecoach	2
Firstbus	1*
Govia	1
GB Railways	1
Sea Containers	1
Other MBO’s	2
	25
of which	
bus operators	15
MBO’s	3

* Also participants in Great Western Holdings

Source: Derived from Table 1.

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Table 3: Estimated Subsidy (£m)

	1st yr	7th yr	Final yr (where franchise is longer than 7 years)	7 yr Subsidy Reduction	Current Turnover
Great Western	59.9	40.09	31.6	19.81	156.0
South West Trains	60.1	40.3		19.8	221.0
InterCity East Coach	64.6	0	0	64.6	217.0
Midland Main Line	16.5	-2.05	-10	18.55	58.0
Gatwick Express	-4.6	-13	-22.6	8.4	27.0
LTS Rail	29.5	20.96	11.2	8.54	53.0
South Central	85.3	34.6		50.7	158.0
Chiltern Railways	16.5	2.9		13.6	22.0
South East Trains	125.4	65.57	-2.8	59.8	215.0
South Wales & West	70.9	38.1		32.8	40.0
Cardiff Railways	19.9	13.3		6.6	5.7
Thames Trains	33.2	0		33.2	46.0
Island Railways	2	1.75		0.25	0.7
Regional Railways North West	191.9		125.5	46.48	47.8
Regional Railways North East	223.2	145.6		77.6	68.0
North London Railways	54.8	16.9		37.9	54.0
Thameslink	-2.5	-28.4		25.9	76.0
ICWC	77	-61.6	-220	138.6	219.0
Scotrail	280.1	202.5		77.6	104.9
Central	198.1	132.6		65.5	65.6
Cross Country	112.9	55.55	-10	57.35	106.0
Anglia	35.9	6.3		29.6	38.0
Great Eastern	29	-9.5		38.5	120.0
West Anglia Great	52.9	-24.8		77.7	119.8
Merseyrail	80.7	60.0		20.7	18.7
Total	**1913.2**	**883.09**		1030.11	**2257.2**

Source: Local Transport Today 13/3/97. Franchises of 7 years 1 month or 7 years 3 months have been treated as 7 years in this table.

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Table 4: Grants to British Railways Board (£m)

	1993/4	**1994/5**
Public Source Obligation	930	1645
PTE's	105	259
Level crossings	32	35
Pensions	54	45
Total	1121	1984

Source: Transport Statistics Great Britain 1996. Table 1.17.

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