The Privatization of Railways in Britain

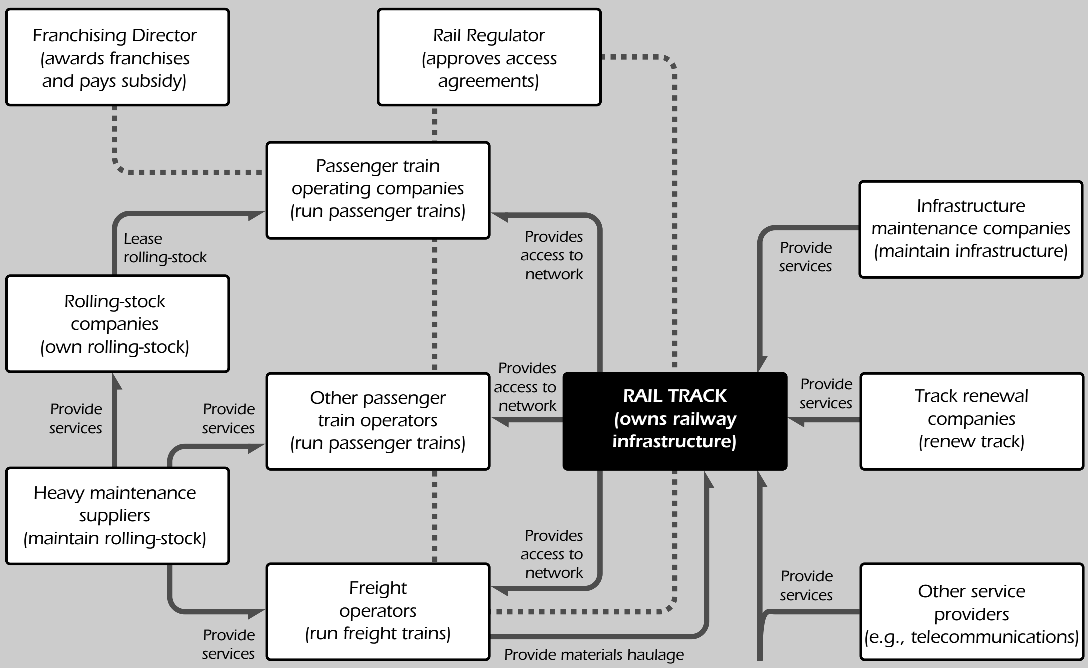
Bill Bradshaw

The privatization of British Rail (BR) will be completed by early 1997. This very complicated and controversial measure has been put into effect since the Prime Minister, John Major, won the General Election in 1992. The proposals for the industry were contained in a White Paper - "New Opportunities for the Railways" published in July 1992. A Railway Bill was put before Parliament in the same year and became law as the Railways Act in November 1993.

The task of privatizing the railways has been very hurried. Government has relied for assistance and advice on very large numbers of consultants who have worked under great pressure. Many of these advisers were involved in the privatization of the rest of Britain's nationalized industries and drew on that experience. The speed of the privatization of the railways has not allowed an opportunity for buyers to take a considered view of the businesses that they have purchased or for the experience of one stage of the process to come into effect before the next stages have begun.

BR was formed in 1948 when the four private railway companies, which had been under a form of public control during WWII, were nationalized. BR was vertically integrated meaning that it owned and maintained its own track and trains as well as being responsible for operations. At that time, BR also built trains, owned hotels and ships and ran a large fleet of lorries to deliver freight. In the late 1960s, a Labour government divested the lorry fleet from BR along with the responsibility for small freight consignments and vested this in another nationalized industry, the National Freight Corporation. Since the Conservative Party came to power in 1979, various ancillary parts of BR have been sold to the private sector, for example, hotels in 1982 and ships and harbours in 1984. However, the railway itself remained as a self-contained operation. Now BR has been split into almost 100 different companies. Instead of one organization operating with one Board of Directors and a single chain of command, there is now a contractual structure where relationships are determined by legal agreements. Each of the new companies depends on many others in order to provide service to the customer. The structure of the new railway is well illustrated in a diagram produced when Railtrack, the company owning the infrastructure, was floated on the Stock Exchange (Fig. 1)

Figure 1 Structure of Privatized Railway Industry



Source: Railtrack Pathfinder Prospectus, April 1996, SBC Warburg

IC225 at Leeds Sation (T. Suga)

The Sale of British Rail

The sale of BR has been organized in three different ways. Some operations have been sold outright. The infrastructure has been the subject of a stock market flotation. The operation of passenger train services is in the course of being franchised—a process due to be completed in March 1997. In all cases, the sale to the private sector has involved the transfer of assets and of contracts negotiated before the sale. Some contracts have a number of years to run. These provide the purchasers of the new companies with the certainty of a future income until their contracts expire. Staff have been transferred to new owners with some limited protection of their employment rights. Other staff have chosen to leave BR under schemes of early retirement and redundancy.

The most important element of the direct sales has been the disposal of the whole fleet of passenger rolling stock—locomotives, coaches and diesel and electrical multiple units. This fleet was divided into three pools, each with a variety of stock. Each pool was formed into a Rolling Stock Company (ROSCO). Leases were drawn up between these ROSCOs and each of the 25 companies responsible for operating passenger train services. When the rolling stock was offered for sale, each ROSCO had a fleet of vehicles and a guaranteed rental income flowing from the leases. Since there was no surplus rolling stock available, the lease rentals represented a very secure investment. Apart from the sale of the passenger rolling stock other important sales included:

- All civil engineering, signalling and electrical traction current supply work. This work was divided between companies specializing in either maintenance or renewal work.
- Maintenance workshops for rolling stock. The passenger and freight train operating companies undertake day-to-day light maintenance and repair of their own trains at depots that they lease around the country. They rely on the maintenance workshops, now owned by private companies, to undertake major overhauls.
- All freight operations including the fleet of locomotives, wagons and carriages used for the conveyance of mail and parcels. The freight companies also supply the locomotives and wagons used for engineering trains required in connection with track repairs.
- Various technical design, testing, procurement, training and research activities although some services like architecture have been closed.
- Train and station catering

The only part of British Rail that has been the subject of a flotation on the Stock Exchange has been Railtrack. This company owns all the track, stations, light maintenance depots and operational land. It is also responsible for managing the timetable, for the operation of signalling and control of trains and for the overall supervision of safety of the train operations. Railtrack plans the development of the network. Railtrack does not undertake engineering work using its own staff. It has contracts with the various engineering companies that have been sold to the private sector and which undertake work on the track. Railtrack relies for most of its income on Track Access Charges paid under contract by the passenger and freight train operating companies. Some income also comes from property that Railtrack owns and from retail activities at stations. It was the intention of the government at the time the Railways Act was passed into law, that Railtrack would not be floated on the Stock Exchange until the rest of the railway activities in Britain had been sold and all the operation of the passenger trains had been franchised to the private sector. The government changed its mind about the order in which the disposal of BR was to proceed when it announced in November 1994 that Railtrack would be floated in the lifetime of the present Parliament (i.e. by May 1997 at the latest). This change of mind was probably the result of two factors: the desire to make it very difficult and expensive for any future Labour government to reverse the process of privatization, and the fact that the proceeds from the sale of Railtrack would be available to the government (possibly for tax cuts) before the next election.

The passenger train operations of BR have been split between 25 separate companies. There are three broad groups: former long-distance InterCity passenger trains, commuting services around London, and regional services including commuter services and those serving the more remote areas of Scotland and Wales. The operations of these 25 companies are in the course of being offered as franchises. Each has been allocated a pool of rolling stock with contracts already in place with the Rolling Stock Leasing Companies. Each also has an Access Agreement with Railtrack which provides for the use of track, stations and light maintenance depots at a pre-determined price.

Other Possible Options for Privatization

Why was such a complicated method of privatizing BR chosen? In Japan and New Zealand, the first steps towards privatization have been a restructuring of the railways to deal with problems of debt and a re-organization to make the companies attractive to prospective purchasers. This has involved revision of laws and other regulations affecting railways, reducing staff, dealing with pension issues, deciding how much property should be sold and how much should be retained by the State. Arrangements for paying for passenger train services that are unprofitable but deemed to be socially necessary, have also been put into place. Having dealt with these problems, clearly-defined enterprises are then available either to be sold or to be floated.

In Britain, the government dismissed the option of privatizing BR as a single enterprise although this was the method of disposal favoured by railway executives. When the British government began the process of national privatization, the gas industry was disposed of relatively early. British Gas was a monopoly supplier. It owned some but not all the natural gas fields. It owned the whole of the storage and distribution system and it had the monopoly of supply to domestic and industrial customers. The government agreed with the company to sell the whole as a vertically-integrated business, although a regulator was appointed to oversee the company's pricing policy and protect consumers from abuse by a monopoly supplier. The sale of British Gas shares was the first popular privatization where shares were offered to the general public. Purchase was made very simple. As well as a low initial share price, incentives by way of discounts on gas bills were given. However, many commentators criticized the fact that British Gas faced no real competition. Gradually competition has been introduced into the gas industry, but, more importantly, when the telecommunications and electricity industries were privatized, provision was made for competition at the outset. By the time privatization of the railways came onto the political agenda, many people argued that the infrastructure should be separated from the operation of trains so that different operators could compete with one another to provide train services along the same tracks. For this to be possible it was said that the management of the tracks, the timetable and the signalling should be placed in the hands of an independent "Track Authority". This subsequently become known as Railtrack.

Apart from selling BR as a whole, other options for disposal were considered. The company could have been split into a few geographically-discrete vertically-integrated companies as has been the case in Japan. An alternative was to divide the system into an InterCity network, a London area commuting business and a Regional company responsible for the remainder of the passenger business. Each company would have controlled all the infrastructure assets over which it was the primary user and managed the signalling, timetable and stations associated with their business. In fact, in April 1992, BR introduced such an organization with the title "Organizing for Quality" under which all engineering costs had been brought under the control of the three Managing Directors of these principal passenger businesses.

Freight is a small part of the railway business in Britain. Freight managers would have paid the costs of the assets that they used exclusively, and a contribution (known as avoidable costs) towards the extra costs that arose on the passenger railway as a result of freight activities.

Neither of these options—the geographical split nor the business sector split—was accepted by the government because neither provided for significant competition on the track. The government therefore became committed in the new legislation to division of infrastructure management from train operation. It was not apparent that the railways in Britain were experiencing any lack of competition. Only in the case of commuting into London do railways in Britain experience any degree of monopoly power which would allow prices to rise without an equal loss of volume. Elsewhere the car, the truck, express coaches and airlines, all of which operate in de-regulated markets, have eroded the railway share of business and provide effective competition.

Another aspect of the government's policy was the decision to franchise the operation of passenger train services. It was recognized very early in the process of privatization that many passenger services would continue to need subsidy. It was thought that the amount of subsidy could be reduced to a minimum through a system of franchising, with frequent competitions for franchisees. It was suggested that franchises would typically last for 5 years and that such a short duration would "keep the franchisees on their toes". With tracks open to other operators (known as "open access") it was believed that competition to provide service and frequent re-tendering of franchises would keep subsidy levels as low as possible. It was perhaps not appreciated at the time that the prospect of competition from "new entrant" operators under the regime of "open access" might deter franchisees or lower the value of their bids. A franchise in any other business normally gives exclusive access to a market in an area. This is described by economists as "competition for the market". The franchises that the British government were proposing were open to competition including "cherry picking" where competitors might offer services when there is profit to be made but leave the franchisee to operate at less busy times. Another feature of franchises elsewhere, such as Argentina, has been the granting of long franchises with a view to encouraging investment. Very short franchises do not encourage investment because they give virtually no opportunity to earn a return on capital.

The Structure of the Privatized Railway Industry

With the change from a nationalized industry with a strong command structure, to an interconnected network of private companies bound together by contracts, there has been a need to develop a framework through which these new relationships can work. Services are purchased on behalf of the government by the Franchising Director. It is his responsibility to publish and consult upon a train service specification called a Passenger Service Requirement (PSR). This becomes the basis upon which potential bidders are invited to express their interest in tendering for the operation for each franchise. The PSR represents the minimum service that the potential operator must provide although any bidder may offer a better service if they wish to do so. Among those bidding for the first seven franchises, bus companies have been very prominent. (Since the British bus industry was deregulated and privatized 10 years ago, there has been rapid consolidation into major groups). In most cases, the existing British Rail managers have attempted to mount buyouts with the backing of venture capitalists but they have met only limited success. The Franchise Director considers the bids. The price bid, which in most cases is the amount of subsidy required by the prospective franchisee, appears to be by far the most important consideration in achieving success. The standard franchise length is 7 years although in some cases this has been extended to 15 years where investment in new rolling stock has been offered. Other quality features such as improved standards of reliability and punctuality, bus feeder services and station improvements appear to have marginal influence on success. The Franchise Director has set a cap on the rate at which the prices of some of the most popular fares can rise.

The Rail Regulator has been in office since December 1993. The Regulator licenses all operators of trains, stations and light maintenance depots and has a duty to monitor and enforce compliance with the terms of these licenses. He approves all Track Access Agreements between Railtrack and passenger and freight train operating companies. He sets a cap on the prices charged by Railtrack for track access. Among the Rail Regulator's duties is the promotion of competition on the railway. This involves encouragement of the provision of passenger services operated in competition with the franchisees. It has been agreed to constrain such competition (known as "open access" competition) until the franchising process is complete and has had time to settle down. The Regulator is also the guardian of consumer interests and a number of Users' Consultative Committees covering various parts of the country report to him.

It will be seen from the short description of the duties of the Franchise Director and the Rail Regulator that many responsibilities, exercised by government ministers in other countries, have been transferred to these agents. It is not yet clear how accountable the Franchise Director or the Rail Regulator will be to Parliament.

EMU of 'South West Trains' *(Stagecoach)*

Sale and Franchising of the Rail Business

Passenger Rolling Stock

The three ROSCOs were established as public companies on 1 April 1994. They took over all passenger train locomotives, coaches and diesel and electrical multiple unit trains. These were valued at the time at £4.5 million. The three companies were sold on November 1995 for £1.8 billion. The three companies are:
Angel Train Company acquired by GRS Holding Co., a joint venture between Babcock and Brown, Nomura and Prideaux and Associates who paid £672 million for the company; Eversholt Leasing acquired by a Management Buyout (MBO) Team with venture capital support for £580 million; Porterbrook Leasing also bought by an MBO with venture capital support for £527 million.

The companies were sold with leases in place (mostly for 8 years) with the Train Operating Companies, which produce a guaranteed income stream. Of this income, 80% is underwritten by the government. The companies also have indemnity against the costs of safety modifications required by law in the future.
The ROSCOs are responsible for the costs of heavy overhaul of trains. Running maintenance is the responsibility of the Train Operating Companies who lease the trains.

Engineering

All engineering: civil, signalling, electrical power supplies, including design, new projects, renewals and maintenance which was previously carried out "in house" by British Rail technical staff, is now the responsibility of private contractors. Six Track Renewals Companies and Seven Infrastructure Maintenance Units (Companies) were created out of the former British Rail Engineering Divisions. These were sold to the private sector with existing staff and assets such as track repair machinery. The new companies have contracts in place to carry out work for Railtrack. These contracts are mostly set up on a geographical basis. In 1996, the value of the contracts is about £750 million. When these contracts expire between 1999 and 2001, the new companies will be expected to bid against one another for work.
The maintenance of the railway telecommunications network is undertaken by RACAL, BR Telecommunications Ltd., on contract to Railtrack.
The large Rolling Stock Engineering Works have also been sold and these compete for heavy overhaul work provided by the ROSCOs. Various rolling stock design procurement and other technical work is provided by specialist service companies created from groups of former British Rail staff. The situation created under privatization is that the major participants in the railway industry, Railtrack, the Train Operating Companies, and the owners of the passenger rolling stock, (the ROSCOs), do not provide much "in house" engineering. Almost all engineering services are purchased under contract from third parties.

Railtrack

Railtrack, the owner of infrastructure and the stations and controller of the timetable and the signalling, was floated on the stock market in May 1996. The network comprises 16,000 route km, 2,500 stations and 90 depots where light maintenance is carried out on rolling stock by the Train Operating Companies. Most stations are leased to the principal Train Operating Company using the station although Railtrack operates 14 main line stations itself.
Safety on the railway is under the overall supervision of the independent Health and Safety Commission. Railway safety is managed by a Railway Safety Case regime. Cases must be prepared by all train and station operators. These identify risks and show how to control them to a level that is as low as reasonably practical. Railtrack must approve the Safety Cases of all operators and be responsible for the safe working of all of its own infrastructure contractors.
Performance regimes relating to punctuality have been agreed between Railtrack and the Train Operating Companies providing that each party shall compensate the other for delays. Railtrack is responsible for any disruption caused on the network, except those delays caused by operators themselves. An operator causing a delay (e.g. a train breakdown) must pay Railtrack compensation and Railtrack in turn pays compensation for the delays caused to other operators.
The turnover of Railtrack in the year ended 31 March 1995 was £2,275 million. Of this £1,955 million came from the Passenger Train Operating Companies in the form of access charges, £191 million from freight operators and the remainder from property. The Track Access Charges are subject to regulation and are at present capped by a formula of RPI-2% meaning that the cost of access must fall, in real terms, by 2% each year. This form of regulation, which is common in Britain, ensures that some of the productivity gains made by the regulated industry are passed back to users.
Shares in Railtrack were made available for a public flotation that was substantially oversubscribed. The company was sold for £1,950 million. This was substantially less than the £5,600 million valuation of the assets made by the government at the outset of privatization. The discount on the sale price was the result of the uncertainties and complex nature of the new structure of the railway industry. The opposition political parties have expressed strong hostility to the principle of railway privatization. They have pledged to introduce legislation which would allow instructions to be given to the Regulator

to force Railtrack to invest a large proportion of its income.

Passenger Train Franchises

The franchising of passenger train operations is well advanced. In June 1996, the last five companies began the process leading to their eventual sale. It is anticipated that franchising will be completed by March 1997. The companies vary considerably in size and geographical complexity.

There has been keen competition in the bidding for franchises. Apart from management buyouts and at least five bus companies, other bids have come from a French-based utility company, and a major shipping company, and interest has been expressed by airlines. The competition authorities have not intervened to stop a bus or coach company bidding to operate a line serving the same area.

The new companies take over businesses where the train service is largely fixed under the terms of the franchise. Changes to the timetable must be negotiated with Railtrack which in turn must negotiate with other operators who may be affected. There is no spare rolling stock available at present. Companies wishing to increase services will either have to re-organize the existing service or order new trains. Many season ticket and other popular fares are strictly controlled.

Each franchisee has fixed contracts for the cost of leasing rolling stock and with Railtrack for access to the track and to stations. These charges, which comprise, in a typical case, 60% of an operator's costs must be paid even in recession. When BR managed the whole railway, it was common for maintenance and investment in infrastructure and rolling stock to be reduced in times of recession.

Franchisees must operate trains punctually and reliably. They must also provide information about all train services on the entire network and sell through tickets to other areas. Failure to operate within agreed levels of punctuality means that compensation must be paid to customers.

Freight

The amount of freight carried on the railways in Britain has declined over the last 40 years. Much less coal and steel is produced now and trucks have captured most new types of freight traffic. The former freight business of BR was divided into Trainload Freight which mostly hauled bulk materials such as coal, oil and stone. This was profitable. Railfreight Distribution handles international traffic which is now increasing with the opening of the Channel Tunnel and automotive products. This company abandoned wagonload traffic from individual consignees some years ago in an attempt to reduce its chronic unprofitability. Freightliner hauls containers mostly to and from ports. It was also loss making. Finally Rail Express Systems operates trains for the Post Office.

Following a consultant's report, the government asked for the profitable Trainload Freight to be split into three geographically-based companies before sale so they could compete with one another. The three companies: Mainline, Transrail and Loadhaul were, however, sold together to a new company, English, Welsh, and Scottish Railways. This was formed by Wisconsin Central which had already purchased Rail Express Systems. Wisconsin Central is the North-American company that purchased, in association with others, the New Zealand railway operation Transrail. Wisconsin has announced that it intends to revive the wagonload business and has ordered 250 new diesel-electric locomotives from General Motors of the United States. Unlike the passenger companies, the freight operators own their locomotives and some of their wagons. Under the new legislation "open access" rights for operation on the railway are available to any freight company as well as to passenger operators. Two organizations: National Power (an electricity generator) and Direct Rail Services (in the nuclear power industry) have entered the market in a small way with their own locomotives and train crews hauling their own traffic.

Rail Link Bus of South West Trains *(Stagecoach)*

Class 60 Freight Locomotive *(English Welsh and Scottish Railways)*

Effect on Public Funds

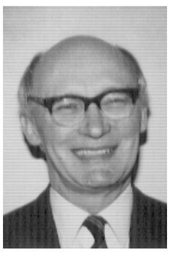
It is impossible to be sure what will be the long-term financial effects of railway privatization. There have been very high transitional costs in setting up the complex structure. There have also been significant costs of redundancies and pensions for staff accepting early retirement. Substantial levels of debt have been written off. It is clearly costing a good deal more for the Franchise Director to purchase services under the new financial regime than it cost the government to subsidize BR through the previous procedures. For example the total cost of buying services from BR in 1993-94 was £1,143 million. In the year ending 31 March 1995, this has risen to £2,009 million. However, some of this money flowed back to government as profits from the ROSCOs, Railtrack and the Train Operating Companies while these organizations remained in public ownership. During the period while the industry is being sold there will also be receipts from the sales themselves.

However, the new contracts stretch forward for several years during which time the profits of the newly-privatized companies will not flow back to government and receipts from sales will dry up. Various estimates have been made of the continuing liabilities of the government in the form of the cost of paying franchisees. It is suggested that by 1997-98, the cost to the taxpayer will settle down to about £1,700 million, still considerably more than it cost to subsidize BR.

Supporters of privatization suggest that a long-term view is necessary arguing that private-sector disciplines will so increase efficiency that the need for public subsidy will fall. Such proponents also point out that the private sector will now have to raise money for investment in the private capital markets which will reduce public sector borrowing.

Will Privatization be a Success?

The government has set no success criteria for the railway in terms of the target market share it should aim to achieve or improvements in quality of service it should aim to provide in terms of frequency and speed. There is no clear set of purposes behind the policy of subsidizing railways. Apart from whether the system costs the taxpayers more or less money it will be difficult to say whether the policy has been successful. Some commentators have argued that targets should be set for the transfer of passenger and freight traffic from the roads to the railways, principally on environmental grounds, but also to reduce road congestion. So far, the government has rejected such arguments.



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Professor Bill Bradshaw joined British Railways in 1959 as a Management Trainee after graduating in Political Economy. He was appointed Director of Operations in 1979, Director of the Policy Unit in 1981, and General Manager of the Western Region in 1983. Following injury, he took sabbatical leave at the University of Oxford and was appointed Professor of Transport Management at the University of Salford in 1986. He became Chairman of Ulsterbus and a Fellow of Wolfson College, Oxford in 1987. He is also a specialist adviser to the Transport Committee of the House of Commons.