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‘A highly successful model’ ? The rail franchising business in Britain

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Abstract

A crucial feature of rail privatisation in Britain was franchising. Passenger services were franchised in competitive bidding processes to train operators which were meant to function with declining subsidy. The paper adopts the framework of social cost-benefit analysis to examine rail privatisation’s impact on three key groups; consumers, producers and the government. It establishes that privatisation did not achieve all the supposed benefits. Further, franchising only appears to be profitable through the use of calculative accounting practices, whereby franchised train operators are portrayed as discrete business entities, whereas they are supported by very substantial, ongoing direct and indirect government subsidies.

Keywords: Rail privatisation; franchising; train operating companies; Railtrack; Network Rail; British Rail

‘A highly successful model’ ? The rail franchising business in Britain

Introduction

Rail was the last and most complex step in a long sequence of nationalised industry privatisations which had been undertaken by Conservative governments since the early 1980s. In a radical departure from postwar railway practice the integrated rail industry was fragmented, with the vertical separation of train operations from the control and maintenance of the infrastructure which became the responsibility of a track authority. The track authority was privatised through a share flotation, while train operations were awarded to franchisees after a competitive bidding process. Apart from its complexity, another unique feature of rail privatisation was that it involved the transfer to private ownership of a loss-making industry which required ongoing subsidisation to provide the services expected. Hence, privatisation was followed by continuing wealth transfers to private rail companies through increased subsidies.

According to the 1992 rail privatisation White Paper, awarding train operations to rail franchisees following a competitive bidding process was intended to improve the performance of previously State-owned British Rail (BR) in several ways. It was expected to bring ‘better use’ of the railways than under BR, deliver greater ‘efficiency’ than the nationalised rail industry, including opportunities to ‘reduce costs’ and deliver ‘better value for money’, and bring a ‘higher quality of service’.¹ The suggested impact on performance of the restructuring and privatisation of a nationalised utility could be evaluated by ‘assessing the impact from actual occurrences’, or to try ‘to predict or simulate the potential impact based on some historic trends’.² The latter approach characterises studies which use social cost-benefit analysis. Recognising the particular contributions of both approaches, and that a comprehensive evaluation of the effects of restructuring and privatisation needs ‘to take into

account a wide range of impacts'³, both methods are used in this study. It analyses the impact of rail's restructuring and privatisation on the actual performance of the industry, and also draws on two social cost-benefit analysis studies of rail privatisation.

Other studies employing social cost-benefit analysis have addressed the impact of complex privatisations such as electricity (Newbery and Pollitt, 1997; Domah and Pollitt, 2001) and rail (Pollitt and Smith, 2002; Preston and Robins, 2013), focusing on the efficiency and distributional impacts. Jones, Tandon and Vogelsang (1990) developed a social cost-benefit methodology to assess the impact of privatisation on the welfare of groups in society. Their methodology estimates the total change in welfare in terms of efficiency gains or losses resulting from the privatisation of industries, and the distribution of this welfare change between three key groups in society: consumers, producers and the government. The key efficiency gains or losses from privatisation are estimated by comparing the difference between the present value of costs under private ownership and the counterfactual of the present value of estimated costs under continued nationalisation. This approach is broadened by the present study which tests the claims for rail privatisation by examining how the performance of the privatised industry impacted on consumers, producers and the government. The analysis focuses on whether, compared to BR, rail privatisation achieved its objectives of: benefiting consumers in terms of lower fares and improved quality of service, resulting in increased passenger numbers; benefiting producers by encouraging greater efficiency and reducing costs; and benefiting government by improving value for money and reducing the need for regulation. Further, the rail franchising model is questioned and shown to be profitable only through the use of calculative practices whereby rail franchisees are portrayed as discrete commercial entities, rather than as recipients of substantial direct and indirect government support. While financial information may be regarded as 'socially

constructed and malleable’, it can still ‘be used to construct alternative narratives that ... question the viability of business models’.⁴

Contrary to the promises of the business model that compelled the fragmentation and privatisation of BR, which was justified on the basis of improved ‘quality of service’ and better ‘value for money’⁵, the railways’ total operating costs have more than doubled since privatisation and the average annual subsidy has more than tripled compared to that received by BR.⁶ Further, after several years of poor performance, the profit-maximising shareholder-owned infrastructure provider, Railtrack, collapsed into administration in 2001. Railtrack’s successor, Network Rail, established as a private, debt-financed company without shareholders, has been heavily reliant on both government subsidies and on government-guaranteed borrowing. A former BR Board member condemned the vertical separation of the railways as ‘an extraordinary mistake’,⁷ while investigations of both the infrastructure provider and franchising by bodies which include the Transport Select Committee have been severely critical. Supporters of privatisation, however, argue that there have been significant improvements in performance in recent years. The body representing train operators, the Association of Train Operating Companies (ATOC), argues that Britain’s unprecedented rail passenger growth resulted from the ‘highly successful’⁸ franchising model and, without any recognition of the significant financial dependence on government, that the operating companies are delivering attractive commercial results.

The remainder of the paper is structured as follows. First, the importance of the calculative practices of accounting in providing the justification for public sector reforms, including privatisation, is discussed. Secondly, the importance of franchising is examined, particularly its contribution to the development of railways in Britain. This is followed by a discussion of the importance of the calculative practices of accounting in providing the

justification for public sector reforms, including privatisation. Then the context of rail privatisation is established using privatisation files from The National Archives (TNA). The subsequent section examines the extent to which privatisation has delivered benefits to consumers in terms of lower fares and improved quality of service (which encompasses rolling stock investment, better punctuality, less overcrowding and improved safety), all of which should encourage passenger growth. This is followed by an analysis of rail's cost structure to determine the extent to which the producers have benefited from greater efficiency, in terms of reducing costs. The penultimate section evaluates the extent to which privatisation has benefited the government by examining the impact on subsidies and on developments in regulation, including the second and third rounds of franchising. The final section provides conclusions on the rail franchising business.

Accounting and the use of calculative technologies in public sector reforms

The belief that accounting simply supplies tools for quantification which can be applied objectively has been conclusively deconstructed and contrasted with the view that accounting is a 'social phenomenon' which is 'more powerful and problematical' than often appreciated.⁹ Accounting can be understood as a process of 'attributing financial values and rationales to a wide range of social practices, thereby according them a specific visibility'.¹⁰ Hence, it is located 'within a broad range of practices of economic calculation'.¹¹ Indeed, accounting 'discourses play a fundamental role in shaping significant historical events'.¹² Accounting does more than mirror or interpret reality, it is involved in the 'complex web of reality construction'.¹³

Miller and Rose have highlighted how 'technologies of government' such as accounting 'seek to translate thought into the domain of reality' and so provide mechanisms through which authorities 'have sought to shape, normalize and instrumentalize the conduct,

thought, decisions and aspirations of others in order to achieve the objectives they consider desirable'.¹⁴ The use of technologies, including accounting, to manage both government and people, originated with eighteenth century European conceptions of government, whose operations were to be realised through 'the accumulation and tabulation of facts'.¹⁵ The calculative technologies of accounting practices made it possible for political rationalities to be implemented as government programmes, while political rationalities accorded 'significances and meanings to quite mundane calculative routines'.¹⁶ Calculative practices become 'endowed with meaning' as they emerge and are used.¹⁷ There is always more involved in accounting than simply the calculative practices¹⁸. Instead, these practices have a strong appeal for governments by apparently offering the prospect of achieving effective administration by following certain 'technical routines'¹⁹ and using the information produced to convince others. In Britain in the mid-1960s, for example, economic growth became a key government objective, and so a central feature of 'the political rationality'.²⁰ Governments, however, could not stimulate growth by controlling individual investment decisions of private firms or nationalised industries. Therefore, they encouraged the use of discounted cash flow analysis in order to instrumentalize the growth objective 'by a specific calculative regime'.²¹

The rise of neo-liberalism in countries such as the USA and Britain brought a reorganisation of political rationalities, while the employment of the calculative practices of accounting in public sector reforms was intended to create and sustain markets.²² The last few decades have witnessed a drive to provide a 'calculative knowledge' of services ranging from health to education. To achieve this, accounting has transformed increasing areas of social life.²³ Although the most visible, and hotly contested, strand of market-focused strategies has been privatisation programmes, neo-liberalism has also encompassed a reorganisation of the government of personal life as the language of entrepreneurial freedom has become predominant in the private and public sectors.²⁴ In the public sector, a range of organisations

from schools to hospitals have been reframed as ‘discrete entities’ pursuing their activities as enterprises.²⁵ Within public sector enterprises budgetary responsibilities were allocated to professionals, such as doctors, who were required to evaluate their actions by translating them ‘into costs and benefits’ that can be given an accounting value.²⁶ Hence, the calculative technologies of accounting as a ‘profoundly normalizing activity’ encompass key aspects of modernity, including setting ‘standards of efficiency’ and ‘seeking to define the ways in which economic surplus is to be calculated’.²⁷

The 1992 rail privatisation White Paper, which was introduced by John Major’s Government, was explicitly framed within a neo-liberal framework. The White Paper asserted that competition for franchises would ‘bring greater responsiveness to passenger needs, improved efficiency and better services’,²⁸ employing the language of entrepreneurial freedom supported by calculative technologies. Train operators enthused by ‘entrepreneurial spirit’ would operate as discrete entities bringing ‘more localised management closer to the public and greater opportunities to ... reduce costs’, and so rail’s subsidy would be eliminated in the long run, when franchisees operating profitable routes would make payments to government.²⁹ The White Paper’s reliance on the language of entrepreneurial freedom rather than empirical evidence was striking, given that it acknowledged BR’s ‘significant’ recent improvements and high productivity.³⁰ The rail privatisation proposals were not only unique in terms of their lack of empirical support, but also in terms of the European context. Supporters of the fragmented privatisation model argued, often retrospectively, that European directive 91/440 required rail’s infrastructure to be separated from operations. However, the separation did not have to be physical but, as implemented by State-owned railways like France’s SNCF and Germany’s Deutsche Bahn, only an accounting mechanism.³¹ The citings of the European directive, and the forecasts of

efficiency savings, were important examples of the use of the calculative technologies of accounting to ‘shape reality’ and so justify the rail privatisation proposals’.³² In the justification of both the concept and the form of rail privatisation, calculative technologies were fundamental.

Franchising and the history of Britain’s railways

Franchising is a business model where the owner of an asset or service, the franchisor, grants another party, the franchisee, the contractual right to market its products or services in a defined geographical area for a fixed period of time. Franchisees are required to follow rules established by the franchisor and usually pay a fee for the right to operate the franchise. Product franchising was developed in the USA in the nineteenth century when manufacturers of expensive and complex goods, such as sewing machines, marketed their output through specialised retailers acting as agents.³³ Business-format franchising, where the outlet itself along with a package of support services is the product, emerged in early twentieth-century America.³⁴ This form of franchising is now typified by the fast food industry, where outlets such as McDonalds have spread globally.

While the origins of franchising in the private sector stemmed from product and business-format models, its use in the public sector has also had a long history. It was used as early as the Middle Ages when franchising referred to services, such as tax collection or road construction, which were subcontracted by the State to private individuals for a fee.³⁵ The development of road transport in Britain in the seventeenth century was facilitated by the use of franchising. Turnpike trusts were organisations which were established by individual Acts of Parliament and given powers to collect tolls to provide for the maintenance of major roads. From the second half of the eighteenth century there was a significant extension of turnpiking and by the 1830s over 1,000 trusts administered around 30,000 miles of turnpike road. Early

British railway companies, such as the Stockton and Darlington, acted like the contemporary owners of turnpike roads and canals by charging competing train operators for access to the track. The development of steam trains soon proved these practices to be both dangerous and inefficient. Individualistic drivers, 'owing allegiance to a variety of operators', had inadequate 'regard for safety' and 'collisions were common'.³⁶ There was also significant litigation between rail companies and franchised operators over repair and maintenance issues, such as the requirement for train operators to maintain their rolling stock in a safe condition, when additional operating expenses meant a reduction in profits.³⁷ Hence, from the late 1830s most railway businesses operated as integrated companies, combining track ownership with train operations. Railways were acknowledged to be a 'natural monopoly', and the 'turnpike' or 'open access' principle was regarded as 'incompatible with standardization of operating practice, essential in a public utility'.³⁸

As rail businesses proliferated, there were conflicting views on the relative merits both of competition and cooperation between companies, and on the desirability of state intervention. Governments vacillated 'between whether competition or monopoly was the most appropriate market structure' for organising rail transport.³⁹ Gladstone's 1844 Railways Act even gave governments the reserve power to nationalise lines where excess profits were made, although this power was never utilised. Hence, debates on the appropriate structure for rail transport and on the issue of 'public ownership versus private enterprise' are 'as old as the industry itself'.⁴⁰ These unresolved debates meant that some regions were poorly served by 'excessive competition', which led to a 'wasteful' duplication of routes, including 'main lines' but also 'lines to and from mining areas, ports, and industrial centres'.⁴¹ In other areas large regional railway companies emerged, and by 1874, fifty years after the opening of the Stockton and Darlington railway, the four largest companies owned 39% of the track mileage

and the top 10 companies accounted for almost 70% of the mileage.⁴² Collectively, railway companies had recognised very early that some cooperation was needed for survival and so the Railway Clearing House was established in 1841. It was ‘a solution to co-ordination between railway companies’, supporting ‘information processing’ and ‘developing structures relating to price and conditions of carriage’, in order to ‘deal with the inherent problems of co-ordinating a natural monopoly’.⁴³

Rail’s major restructuring did not occur until the twentieth century, following the First World War when the network was ‘taken over by the state as an emergency war-time measure and effectively run as an integrated system’.⁴⁴ Building on the benefits of integration achieved in war-time, the 1921 Railways Act reorganised the 120 private rail companies into four regional groupings, which struggled financially as they were subject to price controls by the Railway Rates Tribunal and faced increasing competition from road transport. The subsequent transfer of ownership of industries, such as rail, to public hands after 1945 was partly ‘the logical extension of the previous practice of regulation’ in both World Wars.⁴⁵ The nationalisation of the bus, rail and long-distance road haulage industries in 1948 was also justified on several grounds, including inadequate investment by private companies and the strong elements of natural monopoly and externalities⁴⁶ associated with these industries. The four regional rail companies were merged to form British Railways (which became known as British Rail from the mid-1960s).

Under public ownership, successive governments expected that BR would combine ‘public service aspirations and commercial viability’.⁴⁷ This quest was to be thwarted because BR was subject to the constraints of government policies and fluctuations in the economy. Its financial problems were further exacerbated by successive governments compelling BR to finance its capital investment with interest-bearing public debt and by the generous terms

granted to the former shareholders of the rail companies which were nationalised, when their equity was converted into 30-year loan stock with fixed interest payments which BR was obliged to pay. In the 1970s, BR was criticised for losing both money and market share⁴⁸. Hence, after 1979 a series of Conservative Governments demanded greater commercial efficiency.⁴⁹

The Conservative Governments elected from 1979 demanded greater efficiency from the public sector. Like other nationalised industries, BR was subject to rigorous financial discipline, and in response undertook two major internal reorganisations in the 1980s and 1990s, known respectively as Sector Management and Organising for Quality. Under Sector Management, business criteria were injected into a much wider range of decisions affecting rolling stock, infrastructure and administration, an approach which improved rail finances in the 1980s.⁵⁰ Calculative technologies of accounting were used to provide cost and revenue figures for discrete businesses within BR, such as InterCity and Network SouthEast. BR was set a target by government of making InterCity profitable, a target which was achieved partly through more refined cost allocation, regarded by some as ‘creative accounting’, and partly through the revenue boost gained from higher fares and passenger growth in the late 1980s.⁵¹ The culminating change in BR’s reforms was Organising for Quality, which eliminated the railway’s traditional regional structure and divided staff among sectors, consisting of six businesses and 27 profit centres.⁵² Although these reorganisations were controversial, and involved many redundancies, Organising for Quality led to improvements in both productivity and punctuality and offered the prospect ‘of a more streamlined, consumer-oriented, empowered organisation in an integrated form’.⁵³ While these reorganisations together with the development of a strong business culture were seen by BR’s management as ‘a home-grown solution to governmental attack’, they also arguably ‘created preconditions

for the discussion of privatisation'.⁵⁴ The 'crafted accounts representing the railway as a series of businesses ... permeated through management structures ... to operations on the ground' and so the railway 'has become its businesses'.⁵⁵ Ironically, the successful reorganisation of BR was only completed in 1992, the year rail privatisation plans were announced.

The context of rail privatisation

Prime Minister Margaret Thatcher had been reluctant to attempt BR's full privatisation because such a move was likely to be unpopular and there was a long history of financial losses. However, the Thatcher Government established the Serpell Committee on Railway Finances to review BR's performance and to secure improved financial results. The Serpell Committee 'both prefigured and influenced future events' when the Conservative Government employed consultants to provide critical reports to the Committee, whose recommendations influenced rail privatisation in the 1990s.⁵⁶

Chaired by Sir David Serpell, a former Permanent Secretary of the Transport Department, the members of the Serpell Committee included Leslie Bond, a director of the Rank organisation, Jim Butler from the accountancy firm Peat, Marwick, Mitchell (PMM), and Alfred Goldstein from the consulting engineers R. Travers Morgan (TM). Butler and Goldstein were both senior partners in their respective firms. The latter's appointment by the Thatcher Government was particularly controversial as he was 'an intellectual right-winger ... in favour of converting railways into roads'.⁵⁷ The Committee's work involved a significant conflict of interest, as a large amount of work was outsourced at a cost of £627,000 to the consultancy firms which had seconded Butler and Goldstein.⁵⁸

The importance of the consultants is emphasised in the Serpell Report. The introduction to the Report acknowledged that ‘we have been greatly helped’ by the two firms of consultants who were commissioned to ‘develop and evaluate’ the network options in Part II of the Report and to study BR’s 1982 Budget and Rail Plan.⁵⁹ Part I of the Serpell Report, which examined BR’s finances, drew heavily on the 200-page PMM analysis of the rail industry prepared by Jim Butler, and the network options examined in Part II were based on the options study by TM. The Serpell Report argued that BR was very inefficient and had high costs, which meant that there was significant scope for reducing expenditure on staff wages, track maintenance and lines.⁶⁰ In order to stimulate change in BR the Serpell Committee advocated the introduction of competition and partial privatisation. BR was criticised for being the only major railway ‘other than in India’ to manufacture its own rolling stock.⁶¹ Hence, the Serpell Report advocated reducing costs by fragmenting and privatising BR’s engineering subsidiary, or by tendering for all rolling stock ‘new build contracts’ and contracting out ‘maintenance and repair work’.⁶² It also presented TM’s six network options, ranging from the maintenance of the existing network of 10,000 route miles (miles of train route with at least one track) to a radically reduced and unsubsidised network of 1,630 route miles.⁶³ Whichever option was selected, the Serpell Committee argued that substantial savings could be made by reducing track maintenance work to the ‘lowest level’ consistent with ‘maintaining safety’.⁶⁴

Faced with the Serpell Report’s arguments for cost reductions and line closures, the BR Board arranged leaks before the full report was published which ‘focused media attention on the more draconian prescriptions offered for the network’.⁶⁵ BR gained allies in the press, and both Houses of Parliament, in opposing the Serpell Report.⁶⁶ An internal ministerial group (MISC 94) was established in March 1983 to consider the Report but, with a general

election pending, the political fall-out of ‘a sharp cut in the railways was judged too risky’.⁶⁷ The Treasury submitted a paper to MISC 94 examining the prospects for privatising BR, which cautiously concluded that BR was not a candidate for ‘total privatisation’ where a nationalised industry is ‘broken up into smaller units’ which have to compete in the market place ‘free from government control’.⁶⁸ Several reasons were advanced for this, including that BR can ‘never be entirely free’ from government financial support as historically it has ‘fulfilled social objectives’ which are likely to be retained for ‘political reasons’.⁶⁹ These ‘social objectives’, it was argued, ‘justify a subsidy, and as long as they are retained a railway run exclusively by commercial criteria is not feasible.’⁷⁰ Social objectives for rail had been explicitly accepted in the 1968 Transport Act, which advocated the use of government subsidy to support loss-making passenger services. Further, the railways were regarded as ‘a large and complex system with many joint costs and the inter-dependence of different services’.⁷¹ The Treasury paper did support the experimental introduction of competitive franchising for some passenger rail services,⁷² at the same time making it clear that problems could arise even with a limited franchising programme. There were risks that the bidding process might result in some competitors submitting ‘low bids to win a franchise’, and then the franchising authority subsequently could have ‘great difficulty’ in maintaining a ‘satisfactory’ service.⁷³ Moreover, there was the risk of a ‘cosy’ relationship developing between franchisees and the franchising authority.⁷⁴

The cautious Treasury view of the limited prospects for privatising BR, allied to Margaret Thatcher’s pragmatic instincts, prevailed until the late 1980s. However, although BR had successfully resisted the Serpell Report’s ‘most extreme options for line closures’,⁷⁵ its subsidy and borrowing requirements were strictly controlled and it was encouraged to focus on ‘core’ activities and so sell some subsidiary businesses, including ‘hotels, ships,

surplus property, and mechanical engineering works' to raise funds for infrastructure investment.⁷⁶ These activities conditioned managers in BR to the process of privatising subsidiaries and 'placed them on the slippery slope to full privatisation'.⁷⁷ Further, by the late 1980s major public utilities such as gas had been privatised using share flotations and the Treasury's influential privatisation unit was keen to encourage further privatisation to stimulate competition and reduce the scope of government. Significant publications such as *The Right Lines* emerged from the free market think tank the Adam Smith Institute which supported BR's fragmentation into a privatised infrastructure authority and private train operators which paid for track access.⁷⁸

Margaret Thatcher's successor as Prime Minister, John Major, used rail to demonstrate his Thatcherite credentials, proposing a fragmentation model, involving the separation of infrastructure and train operations, in the Conservatives' 1992 rail privatisation White Paper. The fragmentation model drew on the privatisation of the electricity industry in 1990, where an integrated nationalised industry had been split up in order to introduce competition through the creation of many companies.⁷⁹ The justification for rail's privatisation was presented in strongly entrepreneurial language, invoking the power of the private sector's 'management skills' and 'flair' to transform the industry.⁸⁰ Hence, language was important in rendering the reality of a vertically integrated industry 'amenable' to fragmentation and privatisation.⁸¹ The entrepreneurial language was combined with public policy arguments for franchising, which originated with the nineteenth century social reformer Sir Edwin Chadwick who argued that where 'competition *within* the field' was impossible, auctioning the right to manage a monopoly franchise would allow 'competition *for* the field'.⁸² Franchises would be awarded after a competitive bidding process, with the successful bidder being the one offering the best terms. This approach was developed a

century later by Demsetz who argued that companies should bid for the right to operate public services because ‘the rivalry of the open market’ provides a more effective discipline than regulation.⁸³

BR’s Board and the majority of its senior managers opposed the proposed fragmentation model for the rail industry, arguing instead for ‘a private, but vertically integrated, industry’.⁸⁴ BR’s approach was regarded as obstructive, and so it was excluded from the policy-making arena’.⁸⁵ Instead, the Conservatives turned for support to private sector consultants, often from the Big 5 accounting firms, spending £450 million on consultancy fees preparing for rail privatisation.⁸⁶ Chris Green, a senior manager in the industry, argued that rail privatisation was unique as ‘the nature of the new structure was not decided by experts working within the industry but by people from outside such as consultants, politicians and civil servants’.⁸⁷ The Treasury’s privatisation unit drew on consultancy reports to support rail’s fragmentation and privatisation. An analysis of structural options by accountants Deloitte, Haskins & Sells (DHS) focused on the benefits of separating the infrastructure from operations. The report distinguished between ‘subsidised’ and ‘commercial’ train services, arguing that franchising train operations would encourage ‘competitive pressures’ in franchise bidding, leading to efficiency gains in the form of cost and subsidy reductions.⁸⁸ DHS advocated introducing competition in the privatised rail industry, as ‘competition maximises the information available to shareholders on feasible cost reduction’, thus encouraging the greatest ‘efficiency improvements’, especially where ‘inefficient’ train operators were allowed to go out of business.⁸⁹ These optimistic views about the benefits of franchising were tempered by the report’s argument that the quality of passenger services would be improved by making quality ‘a condition of subsidy’ on

subsidised routes,⁹⁰ thereby explicitly recognising that a subsidy would still be needed in future on some routes.

The arguments supporting the fragmented rail industry model were reinforced and supplemented by analyses in other consultancy reports, such as that of engineering consultants Putnam, Hayes & Bartlett (PHB). PHB's analysis was consonant with that of the DHS report, arguing that fragmentation of the rail network was necessary in order to encourage efficiency through 'competition in the provision of train services'.⁹¹ It argued that regulation would ensure that the privatised track authority used the access charges paid by the franchised train operators to invest in order to maintain and enhance 'the capacity of the infrastructure'.⁹² This was despite the fact that the report acknowledged that there were 'no British or overseas examples' of such a track authority.⁹³

Parker's research using unpublished Cabinet papers and Treasury documents has emphasised that in rail privatisation, 'more than any other, the Treasury drove the form that it took'.⁹⁴ The fragmentation of the rail industry resulted from the belief of 'some ministers and the Treasury that the railways should be a competitive industry', thus the 'ideology of the market' dominated rail privatisation.⁹⁵ While the Treasury hoped that efficiencies from operating in the private sector would lead to lower costs and subsidies for rail, '*there was no serious study of the scope for such efficiency gains within Whitehall*'⁹⁶ (emphasis added).

While the Treasury drew on the optimistic views of the general benefits of competition provided in consultancy reports, both BR and the Department of Transport raised specific issues in opposition to the fragmented privatisation model proposed by consultants. In 1991, a transport expert, Professor Bradshaw, was hired by BR to analyse the PHB proposals. His prescient critique highlighted the risk that the track access charges paid by train operators might not 'cover costs' for the track authority which, unless subsidised, would

not have ‘the cash to maintain standards’ or to ‘enhance the capacity’ of the infrastructure.⁹⁷ He also raised significant misgivings about how ‘capital market disciplines’ could work with the monopolist track authority.⁹⁸ BR’s Chairman, Sir Bob Reid, attempted to raise concerns directly with Ministers. A letter sent to the (then) Transport Secretary Malcolm Rifkind, in April 1991, emphasised the ‘complexity’ of the privatisation proposals, with the need for at least 15,000 contracts because of the multiplicity of interrelationships between individual parts of the railways and the ‘strange looking’ nature of the fragmented model which would ‘be dependent on continued subsidy’.⁹⁹ Concerns about franchise bidding and the financing of the track authority were also expressed in 1991 in a Department of Transport paper. The analysis perceptively highlighted both the risk that the bids of potential franchisees might be ‘unrealistically low’, and the risk that the ‘high cost of major infrastructure renewals means that a capital grant scheme’ might be needed.¹⁰⁰

These cogent arguments had no impact on the privatisation plans, as demonstrated by a briefing note prepared for the BR Chairman’s meeting with the new Transport Secretary, John MacGregor, about the 1992 privatisation White Paper. The briefing note raised points of ‘major concern’ with the privatisation model, predicting that the track access charges paid by franchised operating companies would have a ‘dramatic effect’, leading to increases in both costs and subsidy, and that there could be difficulty in maintaining safety standards as, unlike the existing arrangements, there would not be one Safety Authority to monitor operations.¹⁰¹

Despite significant opposition, which included BR, lobby groups, the Labour Party, and several Conservative MPs, the Major Government’s rail privatisation proposals were implemented by the 1993 Railways Act which introduced a radical separation of infrastructure from train operations. Railtrack, the infrastructure authority, was privatised by public flotation in 1996 and subject to regulation by the Office of the Rail Regulator (ORR)

(later renamed the Office of Rail Regulation, currently named the Office of Rail and Road). By 1997 the rail industry had been fragmented into over 100 companies. These included 25 train operating companies (TOCs), which held fixed-term franchises awarded by the Office of Passenger Rail Franchising (OPRAF), later subsumed into the Strategic Rail Authority (SRA), which also regulated their performance and provided subsidies. The TOCs paid track access charges to Railtrack, which was intended to operate without subsidy. The origin of the franchises was BR's profit centres introduced as part of its Organising for Quality programme, demonstrating the importance of BR's use of calculative technologies in prefiguring privatisation. All network maintenance and renewal work was outsourced to 13 infrastructure companies which made extensive use of subcontracting. Three unregulated rolling stock companies (ROSCOs) supplied the TOCs with leased vehicles.

After the rail privatisation legislation was passed, the case for introducing franchising for passenger rail services was examined further in an academic report prepared for the Treasury. This highlighted the argument that 'franchising has the capacity to reduce costs' compared with public provision.¹⁰² The report examined the circumstances which were most favourable to franchising. These included: establishing a competitive bidding process for franchises; the franchisees bearing some of the 'cost and revenue risks'; the franchisor monitoring the 'quality of performance' of franchisees; and franchises operating for a finite period and being subject to renewal.¹⁰³ The report also presciently identified problems which could arise from franchising, including post-contractual 'opportunistic behaviour' by successful franchisees and the difficulty of enforcing franchisees' 'investment promises'.¹⁰⁴

The main argument for privatisation was focussed on the customer, the passenger, with improved services and better value for money from fares. Accordingly, adopting a broad

social cost-benefit approach, the following section examines the impact of rail privatisation, particularly franchising, for customers.

Impact of privatisation for customers

Improved use of the railways

Rail privatisation was intended to produce welfare gains for consumers, and franchising has been praised for the way that it has led to ‘record numbers of passengers, reversing a downward trend’, thus achieving better use of the railways.¹⁰⁵ Between 1997/98 and 2011/12, passenger journeys increased by 73% to 1,460 million, and passenger revenue increased by £3 billion to over £7 billion.¹⁰⁶ This growth, it is argued, partly resulted from franchising competitions delivering improved marketing and passenger services. Supporters of privatisation also argue that franchising has delivered more investment in the infrastructure by TOCs. In practice, however, the vast bulk of the investment in stations, track and signalling has been delivered by Network Rail. Between 2008/09 and 2012/13, for example, investment by train operators in stations averaged £29 million per year compared to annual infrastructure investment by Network Rail averaging £3.7 billion.¹⁰⁷

Franchising has produced some innovations and product development for passengers. These include the shift towards automated ticket vending machines at stations, the development of websites to improve ticket sales, and recent moves to allow tickets to be booked by mobile phones. The provision of WiFi facilities is also being extended, particularly on long-distance routes. Further, the establishment of National Rail Enquiries by the train companies has improved travel information for rail passengers. Although such changes have made a contribution to passenger growth, they were built on customer-focused reforms introduced by BR which had begun to ‘revolutionise marketing, and showed greater

attention to customer care'.¹⁰⁸ BR's innovations in the 1980s included the extension of railcards to families and young people, and the provision of advance purchase tickets.

Rail passenger growth is driven by many factors, apart from innovations, including social and economic changes. The fundamental economic change, which strongly influenced passenger growth, was Britain's unprecedented period of economic growth which was experienced from the mid-1990s until the 2007/08 financial crisis. Thus, much of the passenger growth would probably have occurred irrespective of rail's ownership. Nash and Smith¹⁰⁹ argued that, while 20% of the passenger growth for London and the South East may result from 'improved marketing or other unmeasured factors following privatisation up to 1998', most of the growth resulted from 'external factors, particularly ... the economy'. Much of the increased passenger growth, argued Preston¹¹⁰, 'is likely to be due to rising incomes'. Hence, the TOCs may be regarded as 'windfall beneficiaries of an unprecedented period of sustained economic growth'.¹¹¹ Moreover, rail passenger growth did not start with privatisation. BR experienced significant passenger growth as the economy recovered from the recession of the early 1980s, with passenger miles increasing by 26% between 1982 and 1988/89.¹¹² Ironically, it was the failure of the centrepiece of the Major administration's economic policy which produced sustained growth after the government was forced to remove sterling from the European Exchange Rate Mechanism in October 1992. This policy reversal allowed sterling to depreciate and interest rates to be lowered, thus stimulating economic growth.

Other exogenous factors were also pertinent in encouraging passenger growth. The regulatory framework facilitated growth, as price capping was adopted for the first seven years of franchising. The price of 46% of rail tickets, including season tickets and savers, was capped at the rate of inflation represented by the Retail Price Index (RPI) for three years, and

then at 1% below the RPI for the next four years. The importance of fare regulation in these early years was demonstrated by the social cost-benefit analyses of the impact of rail privatisation. The results are summarised in Table 1.

TABLE ONE ABOUT HERE

Pollitt and Smith estimated that the key welfare gain in the early years of privatisation was £1.2 billion for consumers, which largely arose from fare regulation, and represented a transfer of the welfare surplus from producers to consumers.¹¹³ This may be seen as inefficient, however, as the overall welfare gain of £1.1 billion achieved up to the year 2000 resulted from ‘adopting business practices that could not be continued in the long run’.¹¹⁴ The TOCs initially attempted to procure ‘efficiency’ savings in the form of redundancies, particularly the ‘overzealous pruning of drivers’, but this led to delays, cancellations and passenger complaints.¹¹⁵ Railtrack’s attempt to save on infrastructure expenditure, particularly maintenance work, led ultimately to the Hatfield crash, which is examined in the following section.

Other relevant changes which encouraged people to travel by train included increased road congestion and major increases in the cost of motoring. The price of the motoring expenses included in the RPI, petrol and oil, vehicle maintenance, and tax and insurance, ‘have increased at a faster rate than rail fares’ since privatisation.¹¹⁶ Rail passenger growth has also been stimulated by societal changes, including the increase in commuting to work and the development of wider social networks.¹¹⁷ Thus, there is considerable evidence that increases in passenger numbers cannot be primarily credited to privatisation. The TOCs and successive governments, however, by emphasising the train operators’ position as ‘discrete

entities' and overlooking the importance of Network Rail's subsidy and borrowing, have shaped a 'narrative' which both defends 'sectoral interests' and validates 'political rhetoric' supporting privatisation.¹¹⁸

Quality of service

The implications of rail franchising for the quality of passenger service using a broad approach to social cost-benefit analysis may be evaluated by examining performance in three interrelated areas: rolling stock investment; punctuality and overcrowding; and safety. Rail privatisation was intended to encourage private sector investment, but the early results were unpromising for rolling stock investment. In its latter days, BR was forbidden from investing in new rolling stock and no new orders were placed in nearly three years before privatisation. Further, the TOCs are 'curious entities' established 'without substantial assets in order to facilitate ease of entry'.¹¹⁹ They lease trains and rent stations, and so have little incentive to directly invest in rail. Instead, the first group of TOCs, whose franchises were mostly about seven years in length, had a strong incentive to sweat their assets by leasing 'cheap, limited-life equipment' from ROSCOs.¹²⁰ The unregulated ROSCOs made 'extravagant' returns on capital employed of up to 26% per year on existing rolling stock in the four years from 1996¹²¹, and so new investment was slow to materialise.

Gradually, investment by the ROSCOs in new trains increased, and over the period 2001/02 to 2005/06 totalled £4.6 billion compared to £1.1 billion over the previous five years.¹²² Passengers benefited from the new rolling stock, with the average age falling from 19.86 years in the final quarter of 2001/02 to 13.2 years in the final quarter of 2005/06.¹²³ More recently, however, rolling stock investment has fluctuated. Investment by ROSCOs in the five years from 2006/07 only totalled £1.7 billion, falling from £326 million in 2006/07 to £274 million in 2010/11.¹²⁴ The falling level of investment was reflected in the increase in the

average age of rolling stock to 20.18 years in the final quarter of 2014/15.¹²⁵ This figure was higher than the average age of BR's rolling stock, 16 years, in 1994.¹²⁶ Recently, however, rolling stock orders and investment have increased, and in 2014/15 rolling stock investment reached a record level of £715 million.¹²⁷ As well as fluctuating levels of investment, there have been problems with both the late delivery and poor reliability of some new trains.¹²⁸ The 2004 rail White Paper identified serious problems with rolling stock provision, arguing that 'markets in rolling stock financing and maintenance' are not working as expected.¹²⁹ In an attempt to remedy these market deficiencies, the Department for Transport in 2009 bypassed the ROSCOs and identified Agility Trains Ltd, a consortium of Hitachi Rail (Europe) and John Laing plc, as the preferred bidder to provide new trains for the InterCity Express Programme.¹³⁰ This project, finalised by the Coalition Government in 2013, is the most significant rolling stock investment programme since privatisation, costing around £7.65 billion to provide 866 new train carriages by 2019.¹³¹ The procurement process was criticised by the Public Accounts Committee, however, for being 'poorly managed' with 'weak' oversight of costs, problems highlighted when Agility offered a revised bid with a 38% price reduction after the project was suspended so that its value for money could be re-evaluated.¹³² Even with this price reduction, informed rail sources argue that the Hitachi trains will cost around 60% more to lease than the more suitable Pendolino trains leased by Virgin on the East Coast line.¹³³

The lack of new investment in rolling stock was one of the reasons for the performance problems experienced by TOCs following privatisation. BR's organisational reforms in the decade before privatisation had enabled it to cope with rising passenger demand while improving punctuality. The performance of InterCity trains improved steadily, with the proportion arriving on time increasing from 77% in 1986/87 to 91% by 1993/94 and

the proportion of all trains arriving on time averaging 90% by 1993/94.¹³⁴ Under privatisation, as Table 2 reveals, overall punctuality declined from 89.8% in 1997/98 to 87.8% in 1999/2000.

TABLE TWO ABOUT HERE

This was followed by a striking fall in punctuality to 78% by 2001/02, which arose primarily from the Hatfield crash in October 2000 and its aftermath. Railtrack's poor contract management, combined with the outsourcing of maintenance and renewal work, led directly **to the crash.**¹³⁵ It was followed by an emergency programme of 'draconian speed limits' around the country because Railtrack, which lacked an asset register, 'found it difficult to establish whether there were more broken rails'.¹³⁶ Railtrack's replacement, Network Rail, inherited 'the consequences of the fragmentation of the railways resulting from privatisation'.¹³⁷ It has taken extensive infrastructure work, underpinned by billions of pounds in capital grants, to gradually return punctuality to the pre-privatisation level and then to reach performance levels of around 90% from 2008/09. There are still significant variations in performance between operators, however, with long distance operators lagging behind the others.

The substantial increase in infrastructure investment following the Hatfield crash 'could be seen as the market correcting' years of underinvestment by BR, when its subsidy and borrowing were both strictly limited by governments.¹³⁸ On the other hand, Railtrack's neglect of network maintenance arguably resulted from rail's fragmentation and privatisation, with the separation of the profit-maximising infrastructure provider from the franchised TOCs, compounded by the failure of the regulatory regime to ensure adequate infrastructure **investment.**¹³⁹ Hence, privatisation 'has exhibited features of both market and regulatory failure'.¹⁴⁰

Apart from punctuality, which is related to infrastructure investment, another key performance indicator for the TOCs is overcrowding. TOCs may be penalised for operating services above the passengers in excess of capacity limit which, for London and South East commuter services, is 4.5% above capacity for the morning or evening peak alone or 3% across both peaks.¹⁴¹ In 2000/01, the SRA reported that five franchises breached the 3% target, the worst performer having 6.6% of passengers in excess of capacity.¹⁴² Overcrowding problems continued over the following decade. In Autumn 2010, three franchises breached the 3% target, the worst performer having 16.6% of passengers in excess of capacity.¹⁴³ Further, an analysis of peak arrivals and departures at London stations in Autumn 2010 revealed that 20.9% of peak arrival services had passengers in excess of capacity, the worst performer carrying 59.1% of passengers in excess of capacity into Paddington station.¹⁴⁴

The complex and expensive regulatory system established at privatisation has had little impact on the quality of rail services, and there have been significant problems with the monitoring of the TOCs' performance. These include undemanding performance benchmarks and an ineffective system of incentives and penalties. Concerns over performance were highlighted by the Transport Committee, which called for higher performance targets and 'exceptionally accurate and rigorous' monitoring of the TOCs.¹⁴⁵ The fundamental problem with attempting to improve the quality of service through regulation is that regulatory mechanisms are difficult to apply to franchises, where 'operating losses' are a characteristic¹⁴⁶ and rail must be maintained as a public service.

A particularly critical, high profile aspect of quality of service is that of safety. BR was staffed by an integrated workforce, which developed a culture where 'safety was nurtured as a habit of thought'.¹⁴⁷ There were fewer deaths in railway accidents in each successive postwar decade: from 344 deaths in the 1940s, to 337 in the 1950s, with major

reductions to 75 in the 1980s.¹⁴⁸ Although there was a falling number of deaths in accidents across the decades, serious accidents, notably Clapham in 1988, still did occur. The Clapham accident, caused by faulty wiring affecting a signal, where 35 people died provided ‘a catalyst for change’ as the findings of the public inquiry provided ‘a comprehensive agenda for the improvement of railway safety’.¹⁴⁹ This improvement was reflected in the fact that in the 1990s there were just eight deaths in accidents up to privatisation in 1996/97. This enhanced safety culture of BR was fractured and weakened by privatisation. There was ‘a direct relationship between post-privatisation organisational changes’ and four fatal accidents, which all originated in the industry’s fragmentation ‘and the neglect of safety considerations between organisational boundaries’.¹⁵⁰ Accident inquiries allocated most of the responsibility to Railtrack, but in the first two accidents the TOCs shared some responsibility. In the 1997 accident at Southall there was a lack of co-ordination between Railtrack and Great Western Trains over the reporting of faults in the train’s early warning system, and the more serious accident at Ladbroke Grove in 1999 exposed the weakness of the driver training programme of Thames Trains.¹⁵¹

Following these accidents, far more attention was paid to safety in the rail industry. Network Rail increased infrastructure expenditure significantly above that of Railtrack.¹⁵² In particular, it introduced the Train Protection and Warning System at a cost of £585 million. This system greatly reduced ‘one the main causes of preventable accidents, trains going through red lights’¹⁵³, and in the eight years following 2006/07 no passengers died as a result of a train accident.¹⁵⁴ There is now far more recognition that safety is a key aspect of measuring performance than when Railtrack followed its profit-maximising agenda. Network Rail’s 2014 *Safety statement* made clear that ‘outstanding safety performance and outstanding business performance go hand in hand’.¹⁵⁵

Another major argument for privatisation was focussed on the producers, who would be encouraged to improve efficiency. Hence, within the paper's comprehensive social cost-benefit framework, the next section examines the impact of rail privatisation on the producers.

Impact of privatisation for producers

Rail's cost structure under privatisation

The Major Government expected rail privatisation to produce welfare gains for producers in the form of 'improved efficiency' which would supposedly result from the franchised TOCs having greater opportunities to reduce 'waste and otherwise reduce costs'.¹⁵⁶ In practice, privatisation led to a very significant increase in the industry's cost structure in the form of interface costs, cash leakages¹⁵⁷ and transaction costs. Interface costs arose from the many profit-seeking companies involved in a supply chain, with each putting upward pressure on prices as they attempted to extract a profit from their contribution to the railway. Substantial cash leakages were introduced in the form of interest payments and dividends required to finance debt and equity, respectively. Transaction costs involve additional costs, such as franchise bidding costs.¹⁵⁸

The principal interface costs arising from rail privatisation were track access charges and leasing charges for trains, which represented the majority of the TOCs' costs. Track access charges were crucial to rail's finances, determining most of Railtrack's revenue and influencing the TOCs' subsidies which were intended to decline progressively to encourage operators to achieve efficiency savings. In 1999/2000, for example, the TOCs received £1.4 billion in subsidy, which underpinned their payment of £2.2 billion in access charges, charges which represented 85% of Railtrack's revenue. The impact of interface costs may be

illustrated by comparing BR's pre-privatisation costs with those of the privatised TOCs. In 1993/94, the last year before BR's reconstitution as an infrastructure provider, its total costs were £3.6 billion, which divided roughly equally into £1.8 billion for infrastructure costs and train operations. In 1997/98, the first full operating year for the privatised rail industry, the TOCs' total costs for passenger operations amounted to £4.8 billion. Thus, privatisation did not bring expected benefits but brought an initial £3 billion increase in costs.¹⁵⁹ While a small part of the rise in costs reflected increased passenger numbers, the most important cause was the interface costs introduced by privatisation, notably track access and leasing charges.

The second significant change in railway finances was the increase in cash leakages, in the form of funds diverted from the rail system to banks and shareholders. BR's pre-privatisation public sector borrowing was £2.5 billion in 1993/94, and its interest payments to government in that year totalled £121 million. Privatisation, by introducing private sector debt and equity, led to a large increase in cash leakages. Indeed, a very significant proportion of the earnings of the subsidy-dependent rail companies continues to leak from the system. Between 1995/96 and 2002/03, for example, the dividend and interest payments of the rail companies totalled £5.5 billion¹⁶⁰, while TOCs have paid a total of £1.5 billion in dividends since privatisation.¹⁶¹ Railtrack's dividend and interest payments before its collapse totalled £1.7 billion¹⁶², and Network Rail's interest payments up to 2014/15 totalled £12.2 billion.¹⁶³

Transaction costs also added substantially to rail's cost structure. Franchise bidding costs alone are estimated at between £3 million to £5 million per company, along with management costs of £2.5 million incurred by the Department for Transport for each franchise award. Hence, the combined cost of one franchise award with three bidders lies between £11.5 million and £17.5 million.¹⁶⁴

The impact of privatisation on costs was predicted both within and outside government. The Transport Select Committee, chaired by Conservative MP Robert Adley, produced a very critical report on the privatisation proposals which raised serious concerns over cost and safety.¹⁶⁵

The cost structure of the TOCs

Competitive bidding for franchises was intended to reduce both costs and subsidy and so produce welfare gains for producers and government respectively. Of the original 25 franchises, 18 were awarded to bus operators, which had not anticipated the rail passenger growth following privatisation. The majority of franchises were awarded for just over seven years, with only two granted for 10 years and five for 15 years.¹⁶⁶ The initial franchise allocation is shown in Table 3.

TABLE THREE ABOUT HERE

The TOCs employed former BR employees and, often, especially in the case of the three successful management buy-outs (MBOs), former managers. The three successful MBO groups soon merged with larger companies (Great Western with FirstBus, Chiltern with John Laing plc and Thames with Go-Ahead).¹⁶⁷ Faced with largely fixed costs in the form of track access charges and train leasing charges, the original franchise bids assumed that labour costs and total operating costs could be reduced. However, there was little ‘waste’ for TOCs to cut out as labour costs, representing 60% of BR’s costs, had fallen significantly before privatisation. There was a 30% reduction in the number of employees in the 1980s, followed by an additional fall of 12% in the early 1990s.¹⁶⁸ Hence, labour productivity improved and ‘remained strong in comparison with other European railways’.¹⁶⁹ Further, BR’s subsidy was only 0.16% of national income compared to the European average of 0.52%.¹⁷⁰ The idea that

BR's costs 'could be reduced substantially' by franchising proved 'illusory', owing to the efficiency gains made by BR in the 10 years prior to privatisation, the optimism of initial bidders, and the cost pressures.¹⁷¹

Telser's critique of franchising highlighted a fundamental problem in awarding franchises to the lowest cost bidders; the neglect of 'demand conditions'.¹⁷² Despite their inclination to save on employee costs, the TOCs soon had to recruit staff in order to meet increased passenger demand. Total labour costs increased by nearly 40% over the period 1998/99 to 2002/03 as the number of employees rose by over 5,000 to 45,000.¹⁷³ This corresponded to 44% more employees than had been budgeted for in the original franchise bids.¹⁷⁴ In the longer term, the TOCs adjusted to the increased passenger demand. The total number of staff employed by TOCs increased by 28% between 1997/98 and 2012/13, rising from 39,721 to 50,782, but productivity improved as the number of passenger journeys made per employee increased by 39%.¹⁷⁵

A further argument for privatisation was focussed on the government, which would gain from better value for money and risk transfer to the private sector. Accordingly, adopting a broad social cost–benefit framework, the following section examines the impact of rail privatisation on the government.

Impact of privatisation for government

Value for money

Government was intended to benefit from the value-for-money approach which franchising was meant to encourage. The scope for welfare gains by government was predicated on the transfer of risk from the public to the private sector. A franchisee in breach of contract by, for example, running operating losses significantly larger than forecast faced penalties, including

the loss of the franchise. In practice, franchising brought very little risk transfer as governments cannot ‘afford to let part of the railway system collapse’.¹⁷⁶ Without subsidy the TOCs would have made total losses of over £1 billion every year from 1997/98 to 2002/03. The initial £2 billion subsidy to train operators was intended to decline steadily and then be eliminated by 2005/06 when net payments to government would be made. Cost escalation meant that the operators’ subsidy continued beyond 2005/06 and that the infrastructure provider has been more heavily subsidised than the TOCs. This is shown in Table 4.

TABLE FOUR ABOUT HERE

Table 4 reveals that the TOCs received over £1 billion per year in subsidy from 2001/02 to 2007/08. Recently, because of passenger revenue growth, the subsidy net of premium payments from profitable train operators fell to £83 million in 2011/12 and then finally became negative in 2012/13. This figure masks significant variations in the TOCs’ financial performance, with 10 out of 19 operators still receiving subsidies in 2012/13 and 2013/14.¹⁷⁷ Further, the infrastructure provider, which was meant to be funded by track access charges, received extensive subsidies in the form of capital expenditure grants. In stark contrast to BR’s average annual subsidy of £740 million in the decade before privatisation, the total annual rail subsidy averaged £3.5 billion between 2001/02 and 2014/15, peaking at over £5 billion in 2006/07 and 2007/08. As network use increased, track access charges were intended to rise to finance additional infrastructure expenditure. This, however, would have necessitated even higher subsidies for the TOCs if they were to avoid operating losses.

The operating profits of the TOCs have varied between 3-5% of turnover since 1997/98, which is only slightly higher than ‘the 3% achieved by BR passenger services in 1992/93’ despite much higher revenues and subsidies.¹⁷⁸ Hence, to protect train operators

track access charges were reduced from over £2 billion to around £1.5 billion in the years after 2008/09 and Network Rail became heavily dependent on government grants and private borrowing. The ORR highlighted how significant this was, emphasising that ‘the fall in direct subsidy paid to TOCs ... does not capture the implicit government subsidy they receive via the network grant’s effect on access charges’.¹⁷⁹ The impact of the increase in costs and subsidy on the rail industry was evaluated by the social cost-benefit study of Preston and Robins, whose results are summarised in Table 1. The study found that within the rail industry the TOCs gained from £2 billion in profits over the period analysed.¹⁸⁰ Hence, the ATOC is able to claim commercial results for the train operators by presenting them as ‘discrete entities’.¹⁸¹ This is a partial view of the overall impact of privatisation, involving the ‘storytelling and folklore of business models’,¹⁸² since the social cost-benefit study found that there had been a loss made by other rail producers and government of £39 billion¹⁸³.

The overall welfare loss of £25 billion identified by Preston and Robins¹⁸⁴ is supported by continuing evidence of an underlying rail industry deficit which is disguised by a combination of subsidy and Network Rail’s annual increases in borrowing. This is shown in Table 5, which summarises the income and expenditure of the rail industry as a whole.

TABLE FIVE ABOUT HERE

As Table 5 demonstrates, there was a rail industry deficit of over £6 billion in 2012/13. This was financed by a combination of government funding of £3.8 billion and an increase in private borrowing of £3 billion. Network Rail’s debt reached £35 billion in 2014/15, requiring interest payments of over £1 billion for the year, and is projected to rise to a staggering £50 billion by 2019.¹⁸⁵

Regulation of franchises

As with all privatisations of industries in the public sector, a key political objective of rail privatisation was to produce a welfare gain for government by reducing the need for political intervention in the industry. It was recognised that regulation of franchises was needed to protect consumers, but this role was allocated to regulatory bodies - OPRAF and then the SRA. A key problem faced by these bodies was that there is always the risk of the 'inability to perform of the lowest bidders', resulting in many examples of renegotiation.¹⁸⁶ In the first franchising round to 2004, the SRA absorbed risk by renegotiating more generous subsidies to financially weaker franchises. Over half of the original 25 franchises had contracts renegotiated, and by 2003 management contracts, where the SRA absorbed most of the risk by financing operators on a cost-plus basis, were in force on nine of the franchises.¹⁸⁷ Even though subsidies were intended to decline annually, the SRA increased the total subsidy to the TOCs by £1 billion between 2001/02 and 2003/04. The SRA's actions in bailing out franchises were subject to much criticism. In the case of Virgin, the subsidy to the apparently 'profitable' West Coast and the loss-making Cross Country franchises totalled £965 million in the two years to March 2004, compared with the planned figure of £37.6 million for that period, and combined net pre-tax 'profits' of the two franchises for the two years of £87 million.¹⁸⁸ The origins of this 'debacle' lay partly in Virgin's over-optimistic franchise bids, but also in Railtrack's poor management of the West Coast Main Line upgrade and the late delivery of the new Pendolino trains.¹⁸⁹ Higher than expected subsidies were a feature of most franchises in 2002/03 and 2003/04, resulting from a mixture of factors: incompetent management by the SRA, over-optimistic franchise bidding and poor cost control by TOCs, and the pass-through of costs and penalties precipitated by Railtrack's collapse, although it is difficult to 'apportion responsibility with any precision'.¹⁹⁰

The SRA moved ‘from being regarded by government as the answer to the railway problem to being seen as part of the problem’.¹⁹¹ The Labour Government, led by Tony Blair, was concerned about rail’s escalating costs and instituted a review of rail privatisation. The review’s trenchant findings were presented in the 2004 rail White Paper which argued that rail privatisation had created a ‘dysfunctional organization’ and ‘a failure to control costs’.¹⁹² Fundamental structural reform was rejected because Blair’s ‘third way’ approach accepted the rail privatisation model. The key organisational change proposed was the abolition of the short-lived SRA. Thus, the Department for Transport acquired the SRA’s responsibilities in 2005, and so government paradoxically gained far greater powers of intervention in the rail industry than it had when BR existed.

The Blair Government did not increase its power to intervene in all franchises, however, as it began to devolve powers in some areas. In 2002, the Transport Secretary agreed that, as it was largely isolated from the rest of the network, control over the Merseyrail franchise could be devolved to the local Passenger Transport Executive (PTE). In 2003, the PTE agreed a 25 year franchise with Serco, the longest to date. Under the privatisation legislation responsibility for letting the ScotRail franchise was devolved, but the 2005 Railways Act significantly increased the powers devolved to the Scottish Government over both passenger and freight services.¹⁹³ In 2007, Transport for London was permitted to award a new franchise for London Overground. More recently, it was agreed that the Welsh Government would take over responsibility for the Wales franchise in 2018.¹⁹⁴

Using its powers acquired from the SRA, the Department for Transport aimed to improve the TOCs’ performance and secure better value for money by tightening up franchise contracts in the second franchising round. The SRA had awarded eight new franchises up to December 2004. The Department for Transport reduced the total number of

franchises from 25 to 19, and in 2006/07 eight new franchise agreements were concluded. The final franchise allocation at the completion of round two, in 2008, is shown in Table 6.

TABLE SIX ABOUT HERE

As Table 6 reveals, there were changes in the franchise allocation compared to the first franchising round. However, bus operators still dominated the franchise map, controlling 15 out of 19 franchises, with Stagecoach also part-controlling the West Coast franchise with Virgin. The majority of the franchises were awarded for between eight and 10 years, but a few longer franchises were also agreed: Chiltern for 19 years, and Wales for 15 years. National Express and Virgin continued with their 15-year franchises from 1996/97 for, respectively, c2c and the West Coast.

The National Audit Office (NAO) argued that the eight new franchises could improve value for money since the franchises' £811 million subsidy in 2006/07 was intended to become a payment to government of £326 million by 2011/12.¹⁹⁵ It also emphasised that Network Rail's infrastructure grant meant that there would still be an indirect subsidy to these franchises of over £900 million in 2011/12.¹⁹⁶ The NAO also expressed further reservations, noting that subsidy reduction depended on passenger growth, and warned that passengers would pay for this both through higher fares and increased crowding.¹⁹⁷ In 2004, the government had abandoned the previous price control formula and replaced it by a policy of increasing regulated fares annually by at least 1% above inflation, in order to enhance the passengers' contribution to rail's rising costs. This policy was strongly criticised by the government-appointed watchdog, Passengerfocus. Based on a study of Britain and seven other large European economies, the watchdog found that the price of commuting to the capital city in Britain was 'high' compared to 'other European countries' while the price of commuting to other British cities was generally 'more expensive' than commuting elsewhere

in Europe.¹⁹⁸ Its 2013 survey found that only 42% of all passengers sampled regarded ticket prices as value for money, a figure which plummeted to 29% for commuters.¹⁹⁹ This was unsurprising when the average price of all tickets increased by 42.5% between January 2004 and January 2011, a period when inflation was 25%.²⁰⁰

Despite attempts to improve performance through tighter franchise contracts, problems with TOCs have persisted. Successive governments expected franchisees to ‘invest, take risks and innovate’ to improve passenger services, but produced a ‘muddle’ by prioritising ‘price’ above other all objectives.²⁰¹ In order to reduce subsidy, refranchising prioritises the extraction of large premium payments from profitable franchises. The East Coast debacle exemplified the dangers of this policy. In 2005, the East Coast franchise was awarded to GNER which, anticipating high passenger growth, agreed to pay a £1.3 billion premium over 10 years. An informed rail commentator argued that GNER:

tried (and largely succeeded) to establish a brand name synonymous with great ideas, sharply focused senior managers, a determination to set high standards, and staff befitting one of Europe’s most established high speed services, winning industry awards and accolades ...²⁰²

Despite such plaudits, GNER’s forecast growth failed to materialise and the train **operator** abandoned the contract. The replacement operator, National Express, contracted in 2007 to pay a higher premium of £1.4 billion over seven years. In 2009, the operator was faced with negligible revenue growth and had to renegotiate terms on its £1.2 billion debt.²⁰³ Like its predecessor, the company handed back the contract. The government then established Directly Operating Railways (DOR) to manage the franchise under short-term public ownership. Despite infrastructure problems, there were improved levels of customer satisfaction and punctuality and the State-owned operator was financially successful. In 2012/13, it made a profit of £4 million after paying a premium to government of £208 million.²⁰⁴

The Coalition Government formed in 2010 was also anxious to deliver savings through refranchising. It accepted the recommendations of the McNulty rail review, established by the Labour Government in 2009, that costs were too high and that franchises should become less prescriptive and longer in order to encourage, respectively, TOCs to flex outputs and to invest more.²⁰⁵ The first attempt to implement this policy occurred in the third franchising round in 2012/13, which began with the provisional award of the new West Coast franchise. After a competition involving four bidders, the 13-year franchise was awarded to FirstGroup, which offered higher premium payments than the incumbent operator Virgin Rail Group. After Virgin sought a judicial review, the Department for Transport discovered serious errors in the procurement process. As a result, the new award was cancelled, Virgin's existing franchise was extended and outstanding franchise competitions suspended. The government established a review of franchising, which represented the third major investigation of rail in under a decade, chaired by Eurostar International's Chairman Richard Brown. The cancellation was also subject to critical scrutiny by the NAO and by the Select Committees on Transport and Public Accounts. The Public Accounts Committee criticised the Department for Transport for not using 'common sense' to question whether FirstGroup's passenger growth forecast was 'too good to be true', despite the fact that its forecast of 10.4% annual growth was higher than Virgin's forecast of 8% , and the prediction of 7% by the two losing bids.²⁰⁶

The implications for the franchising programme of the cancellation of the West Coast competition were examined by the 2012 Brown review which, like the two previous rail reviews, rejected 'major structural change', identifying passenger growth as evidence that franchising was not 'fundamentally flawed'.²⁰⁷ This was consonant with the views of successive governments and the McNulty report which argued that substantial cost savings

are achievable without structural change. Instead, the Brown review proposed franchising reforms, including simplifying the bidding process and reducing the length and increasing the flexibility of franchise agreements.²⁰⁸ While there are examples of relatively successful longer franchises, such as Chiltern which pays premia to the government, the Brown review highlighted a fundamental problem with franchise bidding: the ‘uncertainties of forecasting’, particularly of revenue.²⁰⁹ Brown’s proposed solution of shorter franchises of between seven and 10 years reversed the Coalition Government’s attempt to encourage investment by offering longer franchises. The interventionist responses of successive governments to continuing franchising problems have been aptly summarised as ‘bodging temporary solutions’.²¹⁰

In March 2013 the Department for Transport launched a revised franchising programme of over an eight-year period. Following a recommendation of the Brown review, that franchise competitions should be staggered with a limited number of annual competitions, the Department for Transport has awarded five franchises through competitions but has made 11 direct awards without competition to incumbent operators.²¹¹ The franchise allocation in 2015/16 is shown in Table 7.

TABLE SEVEN ABOUT HERE

As Table 7 reveals, the striking change in the franchise map compared to the two previous franchising rounds is the replacement of the dominance of bus operators by that of overseas operators. Of the 18 franchises, 12 were placed under the sole or joint control of overseas operators. These operators are dominated by subsidiaries of three overseas State-owned rail companies, those of France, Germany and the Netherlands. The majority of franchises, which include the direct awards, will last for between two and eight years, while c2c has a new 15-year franchise to 2029 and Chiltern’s 2010 franchise lasts until 2021. The Public Accounts

Committee expressed concern that ‘the level of interest from the market in rail franchises is dwindling’, highlighting the fact that only three bids were received for each of the five franchise competitions run since 2013, compared to an average of four bids for the previous 10 competitions.²¹² Further, the Committee argued that the Department of Transport ‘has not yet developed the partnerships with operators that are required to support innovation, improve efficiency and improve services for passengers’, highlighting that any reduction to the ‘current level of competition is a major risk to securing value for money for the taxpayer’.²¹³

Conclusions

This paper has adopted the broad framework of social cost-benefit studies to evaluate the impact of rail privatisation on the welfare of three key groups in society: consumers, producers and the government. The claims for rail franchising were tested in this study by examining how the performance of the privatised industry impacted on these three groups, and so analysing the extent to which the main objectives of the 1992 rail White Paper have been achieved. As the foregoing analysis has demonstrated, the main success claimed for franchising is that it benefited consumers in terms of fares and quality of service and so led to a growth in passenger demand. Both the social cost-benefit studies of rail privatisation identify welfare gains for consumers. Although passenger growth was aided by price capping in the early years, and by some innovations and investment introduced by franchisees, the underlying cause was Britain’s sustained period of economic growth.

The quality of service delivered by the privatised rail industry declined significantly in the early years, as evidenced by the limited rolling stock investment, the fall in punctuality

and increase in overcrowding, and the neglect of safety considerations which led to fatal accidents. More recently, the improvements in punctuality and safety have largely stemmed from the infrastructure investment by Network Rail, underpinned by capital grants and increased borrowing.

Alongside consumers, producers were also meant to accrue welfare gains from privatisation in terms of the opportunities to improve efficiency and reduce costs. While franchising may be regarded as a ‘moderate success’ on the demand side, it has ‘failed to achieve its objectives on the cost side’.²¹⁴ Franchising has not delivered the efficiency savings as anticipated, and total rail costs have more than doubled since privatisation while total subsidies have tripled when they were expected to disappear by 2005/06.²¹⁵ The increase in costs and subsidy means that both the industry and government have lost from privatisation, a net welfare loss estimated at £37 billion by Preston and Robins.²¹⁶ There has been a gain by TOCs of £2 billion in profits²¹⁷, but train operators only appear profitable because accounting is used as a calculative technology to portray the TOCs as ‘discrete entities’ in a narrative which ignores the reduction in their track access charges and the indirect subsidy they receive from Network Rail’s capital grants.

As well as losing from privatisation because of the increased subsidies required, governments have not experienced any welfare gains from the expected reduction in political intervention in the rail industry. The Department for Transport now awards and regulates the majority of franchises and determines subsidy levels. Successive governments have made repeated attempts to reform the flawed franchising business, but it remains ‘dysfunctional and expensive’ and ‘in intensive care following the West Coast debacle of 2012’.²¹⁸ The ultimate paradox is that, by 2015/16, the majority of franchises were controlled by subsidiaries of overseas State-owned railways. However, the Coalition Government would not allow DOR,

despite its success in running the East Coast TOC under public ownership, to enter the competition when the line was re-franchised.

The railway industry began in a disaggregated manner with franchising in the 1820s and 1830s, but developed, initially through mergers and ultimately nationalisation, into a vertically integrated network. From the interwar years onwards, the railway industry faced increased competition from road transport and displayed fundamental financial problems. As a highly capital intensive industry, it is difficult to cover full running costs from fares. This dilemma has been critical for the rail industry under both private and public ownership. BR came closest to resolving the dilemma before its privatisation by undertaking major organisational reforms which led to very significant improvements in both productivity and punctuality. Privatisation fragmented the integrated network which had been operated by BR. Although social cost-benefit studies identify welfare gains for consumers, the industry and government are losers as privatisation has increased both costs and subsidy. Further, the rail franchising business sector which has resulted two decades after privatisation is a very curious one, dominated as it is by subsidiaries of overseas State-owned railways.

Table 1 Summary of estimated welfare gains and losses in social cost-benefit studies of rail privatisation

1. Pollitt and Smith

Years included: 1996/97 to 1999/2000

Discount rate 6%

	£billion
Consumers gain	1.2
Producers gain	0.2
Government loses	<u>(300)</u>
Total welfare gain	<u>1.1</u>

2. Preston and Robins

Years included: 1995/96 to 2008/09

Discount rate 3.5%

	£billion
Consumers gain	12
TOCs gain	2
Other producers and government lose	<u>(39)</u>
Total welfare loss	<u>(25)</u>

Sources: Preston and Robins, Evaluating the long term impacts of transport policy, 2013, p. 18. Pollitt and Smith, The Restructuring and Privatisation of British Rail, 2002, p. 497.

Table 2. Public performance measure by sector: percentage of trains arriving on time
1997/98 to 2015/16

Year	Long distance operators %	London and SE operators %	Regional operators %	All franchised operators %
1997/98	81.7	89.5	90.8	89.8
1998/99	80.6	87.9	88.6	87.9
1999/00	83.7	87.1	89.1	87.8
2000/01	69.1	77.6	81.7	79.1
2001/02	70.2	77.8	79.1	78.0
2002/03	70.6	78.9	80.5	79.2
2003/04	73.4	80.3	82.9	81.2
2004/05	79.2	84.7	82.6	83.6
2005/06	82.2	87.9	85.0	86.4
2006/07	84.9	88.8	87.6	88.1
2007/08	86.2	90.6	89.6	89.9
2008/09	87.3	91.0	90.6	90.6
2009/10	88.7	91.4	92.0	91.4
2010/11	87.8	91.0	91.1	90.8
2011/12	89.1	91.7	92.0	91.6
2012/13	87.1	91.0	91.6	90.9
2013/14	86.9	89.6	91.1	90.0
2014/15	87.4	89.0	91.3	89.7
2015/16	87.6	87.8	91.2	89.1

Note: Arriving ‘on time’ is measured as arriving within 5 min of the published timetable for London and the South East (SE) and regional operators and arriving within 10 min of the published timetable for the long distance operators.

Source: ORR Public Performance Measure by sector, 2016a.

Table 3 Allocation of the original 25 TOC franchises in 1996/97

<u>Franchisee</u>	<u>Franchises allocated</u>
National Express Group (B)	Gatwick Express Midland Mainline North London Central ScotRail
Prism Rail (B)	Cardiff South Wales & West, London, Tilbury and Southend West Anglia Great Northern
Stagecoach Holdings (B)	South West Island Line
Connex Rail	South Central South Eastern
Great Western Holdings (MBO/First Bus) (B)	Great Western North West
Merseyside Transport Ltd Trust Holdings (B)	Merseyrail Electrics North East
Virgin Trains	Cross Country West Coast
M40 Trains (MBO/J. Laing plc)	Chiltern Railways
First Bus (B)	Great Eastern
Great North Eastern Railway (Sea Containers)	East Coast
Victory Railway Holdings (MBO/Go-Ahead) (B)	Thames Trains
GB Railways	Anglia Railways
Govia (Go-Ahead/VIA GTI) (B)	Thameslink

Notes: B= Bus operators in sole control or joint venture. MBO = Management buy-out.

Source: Adapted from Gourvish British Rail 1974-97, 2002, p. 517.

Table 4. Government support for TOCs and Railtrack/Network Rail from 2001/02 to 2014/15

	Subsidies to TOCs £m	Capital expenditure grants to Railtrack/Network Rail £m	Total support £m
Year			
2001/02	1,037	499	1,536
2002/03	1,239	792	2,031
2003/04	1,773	1,448	3,221
2004/05	1,267	2,058	3,325
2005/06	1,211	1,985	3,196
2006/07	1,769	3,397	5,166
2007/08	1,433	3,673	5,106
2008/09	554	4,266	4,820
2009/10	755	3,564	4,319
2010/11	249	3,492	3,741
2011/12	83	3,745	3,828
2012/13	(256)	3,780	3,524
2013/14	142	3,453	3,595
2014/15	(679)	3,802	3,123
Totals	10,577	39,954	50,531

Note: The 2012/13 and 2014/15 subsidy figures show overall net payments by TOCs to government.

Source: ORR Government support to the rail industry, 2015d, Table 1.6. Nominal values, unadjusted for inflation.

Table 5. Rail industry income and expenditure in 2012/13

	£bn	£bn	£bn
<u>Income</u>			
Passenger fare income	7.7		
Other income	<u>1.3</u>		
Total income		9.0	
<u>Expenditure</u>			
Network Rail			
Operating costs	2.7		
Financing costs	1.5		
Capital expenditure	<u>4.8</u>		
Total		9.0	
TOCs			
Staff costs	2.3		
Rolling stock costs	1.5		
Other costs	<u>2.5</u>		
Total		<u>6.3</u>	
Total expenditure of Network Rail + TOCS		<u>15.3</u>	
Rail industry deficit (income – expenditure)			<u>(6.3)</u>
<u>Deficit covered by:</u>			
Government subsidy to TOCs + Network Rail grant			3.8
Increase in Network Rail borrowing			<u>3.0</u>
			<u>6.8</u>

Note: Income and expenditure figures exclude track access charges paid by TOCs to Network Rail.

Sources: Network Rail Annual Report and Accounts 2013. ORR GB rail industry financial information 2012-13, 2014b, p. 5.

Table 6 Allocation of 19 TOC franchises in June 2008

<u>Franchisee</u>	<u>Franchises allocated</u>
FirstGroup (B) (FirstGroup/Keolis)	Greater Western Thameslink/Great Northern ScotRail Transpenine Express
National Express Group (B)	c2c (London, Tilbury and Southend) Greater Anglia InterCity East Coast
Govia (B)	Integrated Kent South Central (including Gatwick Express) West Midlands
Arriva (B)	New Cross Country Wales
Stagecoach Group (B)	East Midlands South Western
Serco (Serco/NED Rail)	Northern Merseyrail
Virgin Group (Virgin/Stagecoach)	West Coast
Deutsche Bahn	Chiltern
MTR/Deutsche Bahn	London Overground

Notes: Keolis is a joint venture of the French State-owned railway SNCF (70%) and the Quebec Deposit and Investment Fund (30%). Deutsche Bahn is the German State railway. MTR runs Hong Kong's railway.

B = bus operators in control. The Table is dated June 2008 as this was when the Gatwick Express became part of the South Central franchise.

Source: Adapted from NAO Department for Transport: Letting rail franchises 2005-2007, 2008, p.5.

Table 7 Allocation of 18 TOC franchises in 2015/16

<u>Franchisee</u>	<u>Franchises allocated</u>
Govia (Go-Ahead/Keolis) (O)	London Midland South Eastern Govia Thameslink (includes Southern)
Arriva (Deutsche Bahn) (O)	Cross Country Chiltern Wales
Abellio (Nederlandse Spoorwegen) (O) (Abellio/Serco)	Greater Anglia Scotrail Northern
Stagecoach (Stagecoach/Virgin)	East Midland Trains South West Trains Virgin East Coast
First Group (First Group/Keolis) (O)	First Great Western First Transpenine Express
National Express	c2c (London, Tilbury and Southend)
Serco (Serco/Abellio) (O)	Merseyrail
Virgin Trains	Virgin West Coast
MTR/Deutsche Bahn (O)	London Overground

Notes: Keolis is a joint venture of the French State-owned railway SNCF (70%) and the Quebec Deposit and Investment Fund (30%). Arriva is a subsidiary of the German State railway and Abellio is a subsidiary of the Dutch State railway. MTR runs Hong Kong's railway. O = overseas operator in sole or joint control.

Source: ORR TOC key statistics 2015-16, 2016b.

Notes

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- ²⁰⁶ House of Commons Public Accounts Select Committee, *Cancelling the West Coast franchise competition*, paragraph 8.
- ²⁰⁷ DfT, *Brown review of rail franchising*, paragraphs 1.5, 1.6.
- ²⁰⁸ Ibid., paragraphs 1.11, 1.13, 1.19.
- ²⁰⁹ Ibid., paragraph 4.4.
- ²¹⁰ Abbott, *Modern Railways*, 3.
- ²¹¹ House of Commons Committee of Public Accounts, *Reform of the rail franchising programme*, paragraph 3.
- ²¹² Ibid., paragraph 9.
- ²¹³ Ibid., summary, 3.
- ²¹⁴ Nash and Smith, *Passenger rail franchising*, 30.
- ²¹⁵ Jupe, “New Labour, Network Rail and the third way”, 717-719.

²¹⁶ Preston and Robins, "Evaluating the long term impacts of transport policy", 18.

²¹⁷ Ibid.

²¹⁸ Wolmar, "Pubsect bidders for franchises will never be competitive", 37.

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