

**CRESC: PUBLIC INTEREST REPORT**

**THE  
GREAT TRAIN  
ROBBERY:  
Rail Privatisation  
and After**

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# The Great Train Robbery: rail privatisation and after<sup>1</sup>

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## Preface: About This Report

This is a public interest report based on independent research into the railway sector from the Economic and Social Research Council (ESRC) funded Centre for Research on Socio Cultural Change (CRESC) at the University of Manchester. Karel Williams headed an intensive four month research project from October 2012 to January 2013 when the project's full time researcher was Andrew Bowman. The salary costs of the project were funded partly from the Centre's ESRC grant and partly by the TUC which considered there was a need for an independent, non-partisan academic review of privatised railways and an exploration of alternative models that might better suit the public interest. The CRESC researchers are solely responsible for the contents of the final report but they have benefited from TUC comments on a draft of the report.

The report utilises a variety of sources, primarily drawing upon publicly available information in the form of company accounts, official statistics, media coverage, reports produced by relevant government organisations and trade associations, as well as previous academic studies. Our ability to conduct interviews with representatives from a variety of relevant organisations was limited by time constraints and by our decision to concentrate on accounting data so that we could build the first complete picture of how revenue flows through a sector where profit is politically constructed. The accounting information on rail is opaque and dispersed across many sets of accounts, so that it is difficult to avoid error. As a quality check, we asked Jean Shaoul and John Stittle, two leading, university-based, independent accounting experts on rail, to read

<sup>1</sup> A free copy available to download from <http://www.cresc.ac.uk/publications/the-great-train-robbery-the-economic-and-political-consequences-of-rail-privatisation>

through a draft of this report. Our expert readers did not identify any gross errors: Jean accepts our empirics but differs on interpretation while John raised some matters of empirical detail which we have addressed; any remaining errors and omissions are, of course, entirely our responsibility.

Beyond this, we would make two supplementary points about our relation with our sponsor TUC and about the multi-disciplinary team which produced the report. In both cases, we wish to record our appreciation of their support for, and commitment to, the project

Firstly, within the TUC, we are grateful to Nicola Smith, Head of the Economic and Social Affairs Department and Matt Dykes, Policy Officer for Transport who had the imagination to see that their work could be effectively supported by independent research; and the realism to accept that this final report would inevitably diverge from the Unions' position when it came to analysis and recommendations. We thank Nicola and Matt for their support and would stress once again that responsibility for the report and its policy recommendations rests entirely with CRESC researchers. The report does not reflect the corporate position of the TUC, or of individual officers within it.

The CRESC centre continues to facilitate and support radical, interdisciplinary research in a way that is unique. With Andrew Bowman taking primary responsibility for research and drafting, Sukhdev Johal worked on accounts. A team of Manchester and Open University academics from diverse backgrounds closely supported them, assisted in this case by the venture capitalist Peter Folkman who once again has brought an invaluable business perspective. This research team has in different combinations now worked together on a variety of related projects on the on-going financial crisis and on industrial policy choices, partly through collaboratively funded public interest research. Recent CRESC outputs include *Bringing Home the Bacon* a report on meat supply which was co-funded by the ESRC and the VION meat processing company.

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## Glossary

ATOC	Association of Train Operating Companies. The trade association set up by the passenger train operators to represent their interests, following the start of privatisation in 1993.
BR	British Rail. The publicly owned operator of the national rail system between 1948 and 1997, when the privatisation of the rail system was completed.
BREL	British Rail Engineering Ltd. The publicly owned rail systems engineering operation that was part of British Rail prior to privatisation. After privatisation it was bought out by a consortium including ABB, Trafalgar House and BREL managers. Ownership later passed to ABB and then to Bombardier Transportation.
BTC	British Transport Commission. The organisation that oversaw the nationalised rail system, as well as canals and road haulage. It came into life in 1948 and was abolished in 1962 when it was split into five separate boards, including the British Railways Board, each covering different transport systems.
Brown Report	Richard Brown's (Chair of Eurostar) January 2013 report for the Department for Transport on rail franchising, commissioned following the collapse of the West Coast Mainline franchising process in October 2012.
Cap and collar	The 'cap-and-collar' system was part of the train operating franchise agreements, introduced in 2004 to help manage the risks related to passenger fare revenues faced by franchisees. Cap and collar arrangements come into play in year four of the franchise and allow: a) where a franchise's revenue from passenger fares is less than expected, they will receive more subsidy; and b) where a franchise's revenue is more than expected, they will receive less subsidy. The cap and collar system was replaced by a new 'risk sharing' mechanism in 2012.
Competition Commission	The non-departmental public body charged with investigating mergers, markets and regulated industries under to competition law in the UK.
CP	Control Period. Network Rail works with five year control periods for the purposes of planning and finance. Control period one was 1 <sup>st</sup> April 1996 to 31 <sup>st</sup> March 2001 (under Railtrack plc at that time). Control period 4 began on 1 <sup>st</sup> April 2009 and ends on 31 <sup>st</sup> March 2014.
DfT	Department for Transport. The central government ministry with responsibility for rail policy.
DOR	Directly Operated Railways. This is a holding company set up by the Department for Transport in 2009 to run rail franchises where the TOC has walked away or defaulted on the contract. DOR was established to run the East Coast Mainline

after National Express East Coast defaulted and could, in principle, operate other rail franchises, including on a temporary basis between TOC franchisees.

EBIT	Earnings (profit) before interest and taxation. EBIT is roughly equivalent to operating profit.
ECML	East Coast Mainline. The franchise for the East Coast electrified line from London to Aberdeen.
Franchise	Rail franchising was created by the 1993 Railways Act. The UK passenger network is divided into a number of franchises, each of which is periodically tendered and a contract awarded to a train operating company (TOC). 25 franchises were originally created after privatisation; this was subsequently reduced to 17 via consolidation. The franchise gives the right to run rail services within a particular area and over a specific period of time, in return for the right to charge passenger fares and receive financial support from the franchising authority.
GDP	Gross domestic product. A standard measure of national income.
GNER	Great North Eastern Railway, the train operating company (TOC) which was a subsidiary of Sea Containers, and operated the East Coast Mainline franchise from 1996 until 2007.
HLOS	High level output specification. This is issued by the Department for Transport at the start of a control period outlining what the Secretary of State wants the railway system to achieve and how.
ICWC	InterCity West Coast. The passenger railway franchise for the West Coast Main Line between London and Glasgow.
Laidlaw Report	Report by Sam Laidlaw (Chief Executive of Centrica plc) into the actions of the Department for Transport in the award of the franchise for the West Coast Mainline in August 2012 to First Group and its subsequent withdrawal in October 2012.
McNulty Report	Report by Roy McNulty, <i>Realising the Potential of GB Rail</i> , the report of the Rail Value for Money Study, published in 2011. The report was sponsored by the Department for Transport and the Office of Rail Regulation.
NAO	National Audit Office.
Network Rail	A not for dividend organisation that took over the management of the rail network after Railtrack PLC went into administration in 2002. Network Rail owns the track, signalling, bridges, tunnels and most stations (but not the rolling stock). Apart from the largest mainline stations, most stations are managed by train operating companies that run services in and out of the station.

NPV	Net present value. The discounted value of future cash flows, allowing for the effect of inflation.
NXEC	National Express East Coast. The train operating company, a subsidiary of National Express, which ran the East Coast Intercity franchise from 2007 until default in 2009.
ONS	Office for National Statistics.
OPRAF	Office of Passenger Rail Franchising. A statutory body created by the 1993 Railways Act to sell passenger rail franchises to train operating companies, and replaced in 2001 by the Strategic Rail Authority (SRA).
ORR	Office of Rail Regulation. A statutory body created under the 1993 Railways Act, with responsibility for regulation in the areas of safety and economic performance. The ORR should protect the interests of rail users through ensuring competition, efficiency and economy in the provision of rail services.
Premium payment	Under the terms of some rail franchises, a premium payment is paid by the train operating company to the Department for Transport. The agreed payments will not be the same in each year of the franchise, but will generally increase according to a profile, where the premium payments are usually higher in later years of the franchise. Franchises that are not expected to be able to make a profit may not be required to pay a premium. Bids to run rail franchises include details about how much subsidy will be required and the value and profile of premium payments to be made.
PPM	Public performance measure. This is a composite measure of performance that incorporates punctuality and reliability of the passenger rail services operated by the TOCs. It was introduced by the SRA in 2000 as an attempt to capture some elements of service quality in relation to the published timetable.
Railtrack	Railtrack was the public limited company (PLC) created in 1994 by the 1993 Railways Act to own and manage the railway infrastructure – including track, bridges, tunnels, signals and stations (but not rolling stock). Railtrack was listed on the London Stock Exchange in 1996 and went into administration in 2002 after a series of accidents, concerns about the lack of improvement to the rail system and a collapsing share price.
RAB	Regulatory asset base. This is the imputed value of the rail infrastructure owned by Network Rail (and its predecessor, Railtrack), as calculated by the rail regulator (the ORR).
ROCE	Return on capital employed, calculated as the profit earned during a period divided by the long term capital in the organisation at the end of that period. Profit can be pre- or post-tax; capital employed includes long term debt and equity.

ROSCO	Rolling stock operating company. The ROSCOs own, maintain and replace the rolling stock (engines and carriages) which are leased to the TOCs. A number of ROSCOs were created after rail privatisation, and most have subsequently changed ownership.
RPI	Retail price index.
SPV	Special purpose vehicle. A limited company or other legal entity created to fulfil a specific purpose. Often used by companies to isolate the parent from particular financial risks relating to a specific project or asset. Thus, a rail franchise may be run by an SPV owned by a larger corporation. An SPV can also be invested in by other entities.
SRA	Strategic Rail Authority. A non-departmental public body, established in 2001 to award and ensure compliance with passenger rail franchises. It replaced OPRAF and was, in turn, abolished in 2006, with its functions transferred to the Department for Transport.
Subsidy	<p>Financial subsidies are cash payments made to companies in the rail sector.</p> <p><u>Direct subsidies</u> are publicly disclosed payments from the exchequer made directly to individual companies e.g. revenue support grants paid to TOCs, which appear as a line in TOC accounts.</p> <p><u>Indirect subsidies</u> are undisclosed payments from the exchequer where the ultimate corporate beneficiary is not the immediate recipient of the grant. For example, the government's network grant to Network Rail becomes an indirect subsidy when applied towards lowering track access charges paid by the TOCs, without the disbursement appearing as such in the accounts of Network Rail or the TOCs.</p> <p>Subsidy regime during Railtrack's tenure: Railtrack did not receive direct subsidies from the state. The government arranged for TOCs to receive cash subsidies which were applied to paying a share of the TOCs' track access charges to Railtrack.</p> <p>Subsidy regime since the formation of Network Rail: Network Rail receives a grant from the government which is applied to lowering track access charges for the TOCs. During Railtrack's tenure, these subsidies were paid directly to TOCs.</p> <p><u>In the case of TOCs, it is possible to calculate net direct subsidies</u> i.e. direct subsidies less premium payments made by the companies under the <u>terms</u> of their franchise to the DfT. A positive net subsidy means that transfers to the companies exceed premium payments made; a negative net subsidy means that these payments exceed subsidies.</p> <p>While TOCs make much of their net subsidy position, this does not include indirect subsidy via low track access charges. From a social point of view, the</p>

relevant measure of TOC contribution and cost to the exchequer is net direct plus indirect subsidy.

SLF	Subordinated loan facility. Train operating companies are required to provide a form of surety against their default on a franchise. This is the amount that a franchisee would lose if default were to occur. The size of the SLF is negotiated for each franchise and will depend on the expected risk of the TOC walking away. There is no published model that explains the formal method of calculation.
TOC	Train operating company. These are businesses that run passenger rail services, usually through (and according to the conditions of) rail franchises. Many of the TOCs are subsidiaries of giant transport companies (including publicly owned European rail companies, UK bus PLCs and other transport operators).
TAC	Track access charges. These are payments made by train operators to Network Rail for use of the infrastructure.
WCML	West Coast Mainline. A number of connected lines up the west side of Britain serving Birmingham, Manchester, Liverpool, Preston and Glasgow. The WCML includes the Intercity West Coast franchise from London to Glasgow.

## EXECUTIVE SUMMARY

### (a) privatised rail as a serial shambles creating artificial profits for the franchise holders and hidden costs for the public

- Rail privatisation was promoted in the early 1990s with promises of a better, cheaper service for rail users requiring less subsidy by tax payers. Private rail companies would bring in capital and their business expertise which would transform the sector's performance.
- Twenty years later, the privatised rail system requires billions more in tax payer subsidy each year (p. 24, exhibit 7) and has failed to bring in adequate private investment in track or trains (pp. 24-5) so that average age of rolling stock has actually increased (pp. 25-6, exhibit 9)
- Rail privatisation created a situation whereby risk and investment averse private companies positioned themselves as value extractors, thanks to high public subsidies. Government effectively took the operating risk, covering operating deficits and supplying investment funds.
- Train Operating Company (TOC) franchises are a low-cost option on upside profits with downside risks passed to the state. The tax payer loses in a 'heads they win and tails we lose' (pp. 33-4) situation so that Virgin and Stagecoach have since 1997 taken £500 million out of the West Coast main line (pp. 34-6, exhibit 18).
- TOCs can make profits only because since 2002 the quasi-public Network Rail runs the infrastructure with a public subsidy of around £4 billion each year (pp. 58-61, exhibit 28). Less direct subsidy for the TOCs is balanced by more public subsidy and debt guarantees for Network Rail and in this way the Treasury keeps many of the costs of rail off the public balance sheet and creates the illusion of profitability among TOCs (pp. 73-6, exhibit 40).
- Network Rail's low track access charges are a massive indirect subsidy to the TOCs who have been paying less in charges even as they use the infrastructure more (p. 61, exhibit 29). The cost to the public is the higher annual subsidy for Network Rail plus an accumulated £30 billion of government guaranteed debt on the balance sheet of Network Rail (pp. 66-8, exhibit 35) which now spends more on debt interest payments than on railway maintenance (pp. 71-2, exhibit 38).
- Franchising functions as what we call predatory contractualism, because the bidding process encourages companies to game the system with optimistic projections of passenger numbers and back loaded premium payments (e.g. First Group 2012 bid for West Coast main line pp. 90-7, exhibit 52). Franchisees can take easy profits in the early years and then walk away to avoid large premium payments.

- In train leasing, the Rolling Stock Operating Companies (ROSCOs) do deliver a trickle of investment at a high price because they all make high profits at no risk (pp. 45-8) through a value extraction process that has led to a decade of public criticism but only very modest reform.
- Entrenched private interests now dominate the rail reform agenda, as in the TOC friendly 2013 Brown Review. The DfT is in a relation of co-dependence with the TOCs, in which its success is conflated with the success of private companies profiting from the rail system. Risk and investment averse corporates will continue to game the system because long term revenue streams are inherently unpredictable and because the appearance of competition and markets requires low barriers to entry, and thus also to exit (pp. 97-9).
- The trade association of TOCs (ATOC) adds confusion to the situation. In ATOC's misleading narrative, the TOCs claim the credit for increasing passenger numbers which are actually a dependent variable driven by GDP growth and other economic factors bearing no relation to performance of the TOCs (pp. 103-6, exhibits 55 and 57); ATOC also cites passenger surveys on service punctuality and staff service while dodging public concerns about high fares (p. 110, exhibit 61).
- The claims about the superiority of private management and the necessity of profit incentives are countered decisively by the test case of Directly Operated Railways, which has operated the East Coast main line since the private operator walked away in 2009. It has a commendable record on all the indicators which ATOC emphasises (pp. 118-9).
- Successive governments have not engaged sector specific problems in the railways about the discrepancy between low private returns and high social returns, which are highlighted by the business historians of rail (pp. 122-3). Under private ownership before 1948, the sector struggled to make profits and fund investment because operators recovering cost from fares did not capture diffuse and much larger social returns (pp. 123-4).
- Public ownership under British Rail after 1948 is widely stereotyped as an awful failure. The academic histories show that BR was politically discredited by operating losses and economically undermined by low investment; but cash constraints and corporate reorganisation at BR did finally produce an organisation that could achieve better than European mainland level of efficiency, which was lost after privatisation (pp. 126-30)
- Central government is part of the problem because rail policy since privatisation has taken the form of hurried improvisation and hyperactive reorganisation. This masquerades as rational reform while delivering the next instalment of serial shambles. Businessperson led rail policy reviews and the official mentality in the DfT are part of the railway problem, not the solution
- This continues with the current regulatory regime change where a 2012 White Paper (pp. 135-42) builds on McNulty's business-led policy review (pp. 131-4) and TOC friendly reform agenda. However, realigned incentives for over-empowered TOCs and the break-up of Network Rail are very unlikely to deliver the projected efficiency savings.

## (b) fundamental reform and sectoral fixes

Our aim is to provide a new way of understanding the problems of privatised rail, and encourage political debate toward new directions for policy. This depends on answering fundamental questions and addressing preconditions of reform outside the railway sector as well as proposing practical and immediate sectoral fixes which could go into a mainstream party manifesto at the next election:

### What are railways for?

1. Railways deliver connectivity which should be regarded not as an economic good for private interests but as a social right in high-income countries in the twenty first century. A dense network of services and cheap travel is an everyday necessity.
2. The delivery of connectivity via rail has been an intractable problem (under private or public ownership) because the business model of charging fares to passengers often does not recover operating costs. Put another way, the problem is that rail subsidies are required because unearned social gains from the railways - in particular property price rises - are not captured by operators.

### Out of sector changes: the preconditions of reform

3. Socially intractable problems like rail finance do not yield to direct reform because they require out of sector changes and the invention of new social technologies which meet political resistance because they redistribute resources, power and knowledge.
4. Fundamental reform of the tax system is required so that society retains the unearned increment created by rail in the form of increased land prices arising from rail construction and improvement. Hence, the case for a land value tax on the market rental of land with the proceeds applied to infrastructure improvement.
5. Regional government within a federal polity is required to provide a framework for political accountability and financial cross subsidy as long as the railways have to provide both an integrated national network and intra-regional services. Hence transport should be a key function of regional government with tax and spend powers.
6. A redistribution of expert knowledge is the precondition for the political formulation of sensible choices. The requirement here is for sector specific knowledge of rail located in ministries and public universities. Lay political debate requires intelligible accounting information on rail finances, and there is an urgent need for improvement in this area.

## Sectoral fixes

7. Sectoral fixes are about endowing railways with an organisation that aligns with historical experience and current realities; the current Coalition's plans for reintegration of track and train through super TOCS instead aligns with the corporate reform agenda.
8. Fix one: Abolish the TOCs as their franchises expire because they take artificial profits while making a negligible contribution, and this is the only sure way of removing corporate lobbying and influence over the rail reform agenda.
9. Fix two: Integrate track and train operations around a new publicly owned "National Rail" (built around Network Rail after cleaning up its balance sheet) on the understanding that operations should be cash constrained.
10. Fix three: Separate capital expenditure and major projects as the responsibility of another publicly owned company "Rail Engineering" on the understanding that capital expenditure should be generously funded.
11. Fix four: Eliminate the ROSCOs by purchasing their stock as leases expire and make Rail Engineering responsible for new rolling stock procurement and supply.
12. Fix five: Offer National Rail a counter cyclical mechanism for compensation for variations in GDP growth.
13. Fix six: Raise crucial extra revenue for capital expenditure and low ticket prices with a rail precept to business rates, taking a portion of the unearned increment from private enterprises which benefit from their proximity to the railways.

## The political limits of fixes

14. Sectoral fixes are precarious because they would not politically legitimise the organisation of National Rail which would face disruption from politically un-reconciled elements in the press, on the Conservative back benches and among business lobbies.
15. So the question is whether the Labour Party (and other opposition elements inside and outside parliamentary politics) can move beyond rhetorical and generalised moral positions on good and bad capitalism to engage rail sector specifics and address out of sector reform preconditions?

## The Great Train Robbery: rail privatisation and after

### Bamboozled about privatised rail

*(Virgin) won the franchise in 1997 with an agenda to change radically the way people viewed and used the train. At the time the track was run-down, staff demoralised, the service riddled with delays and reliant on heavy subsidies. We set hugely challenging targets to dramatically speed up journey times with modern tilting trains, increase the frequency of the service, improve the on-board experience; as well as double passenger numbers and return the line to profit.*

*We were told it was 'Mission Impossible' and our plans were laughed at by critics. However, 15 years later, despite continued problems with the track, we have achieved our targets. Passenger numbers have more than doubled to over 30 million, the fastest growth in the UK and world leading. We have the highest customer satisfaction of any long distance franchise operator and dominate the air/rail market between London and Manchester. It has been a remarkable achievement by an outstanding team who have successfully delivered on our promises.*

*Under our stewardship, the West Coast Mainline has been transformed from a public liability into a valuable asset for the UK, worth many billions of pounds. The service is a British success story and one to put up against rail companies around the world.*

(Richard Branson in a press release of August 2012, on Virgin's operating record on the West Coast mainline, after First Group had been preferred in a refranchising competition)<sup>2</sup>

The British are bamboozled about privatised railways. They are confused because, as with other complex issues, political attitudes and public opinions depend on how issues are framed and how questions are asked, so that the answers are sometimes contradictory. The form and nature of opinions offered depend on what questions the pollsters ask, and attitudes vary according to what has been most recently in the news. Once confusion sets in it is often difficult to make sense of what is going on in a complex system, particularly where privatisation empowers corporates who define a reform agenda that advances their private interests while Whitehall and Westminster often appear to have no interest in the difficult task of proposing an alternative. Civil servants are invested in the privatisation status quo and, like Westminster politicians, benefit from corporates addressing reform in a way that creates an impression of progress and distracts from the failure to confront sector specifics and accumulating problems.

<sup>2</sup> Virgin Trains, 'Statement: from Sir Richard Branson, Founder Virgin Group', 15/08/2012. Available at <http://mediaroom.virgintrains.co.uk/2012/08/statement-from-sir-richard-branson.html>

Public opinion polls frequently show that a majority of respondents favour renationalisation of railways. The public has a negative view of the rail system, which, according to official calculations now receives just under £4 billion of public subsidy each year and yet charges expensive fares for travellers. One turning point here was state takeover of the East Coast Main Line in 2009 after the franchisee had walked away; a Politics Home survey then found that 51% of all respondents favoured renationalisation and a further 18% favoured more government involvement short of renationalisation.<sup>3</sup> Subsequent polls show even greater public antipathy toward privatised rail. Two thirds of respondents in an October 2012 poll carried out by Vision Critical for the Daily Express favoured re-nationalisation<sup>4</sup>, as did 70% of respondents in a GfK NOP poll carried out for Rail Media in September 2012.<sup>5</sup>

Ownership, however, is only one aspect of a complex system where demand for train travel is cyclical, where passenger fares cannot cover the costs of running, let alone improving the network, and where contracts have done a poor job of protecting the public interest. As we will argue in chapter 7 of this report, British Rail's record on operating efficiency was very creditable; but, before 1993, the public stereotype of British Rail's organisation and service was negative as nationalised railways were an object of contempt rather than a national treasure like the NHS.

These confusions are played on by the train operating companies who have a well-rehearsed PR story about how they are working in the public interest. We opened our report with a quotation from a Virgin press release but broadly similar claims and assumptions suffuse the policy briefings of the Association of Train Operating Companies (ATOC), which, according to its web site 'brings together all train companies to preserve and enhance the benefit for passengers'. The same public that favours renationalisation of the railways can at times also accept the self-serving claims of (some) train operating companies. When Virgin lost its bid for the West Coast franchise in August 2012, more than 150,000 members of the public, including Jamie Oliver and Dick and Dom, signed an online pro Virgin petition on the Downing Street web site because they accepted Richard Branson's claims that Virgin had made more and better trains run on time.<sup>6</sup>

It would be wrong to blame those who signed the petition. Brecht was quite right when he ridiculed the idea that the problems of a polity could be fixed 'if the government dissolved the people and simply elected another'. British electors and taxpayers are inevitably confused because their information comes from the media, which reports events and does not generate analysis of a complex double system, which physically moves passengers and freight between destinations and financially shifts subsidies and profits between companies. These financial flows are complicated and are not coherently laid out in any public document or on the web site of the Department for Transport. The Office of the Rail Regulator (ORR) is less a source of intelligible information and more the custodian of fading hopes because its 'vision' is one of British railways with better safety and

<sup>3</sup> PoliticsHome, 'Majority of public support full railway nationalisation' 02/07/2012. Available at [http://www.politicshome.com/uk/majority\\_of\\_public\\_support\\_full\\_railway\\_nationalisation.html](http://www.politicshome.com/uk/majority_of_public_support_full_railway_nationalisation.html)

<sup>4</sup> Daily Express 'Poll demands railways must be renationalised' 21/10/2012. Available at <http://www.express.co.uk/posts/view/353370/Poll-demands-railways-must-be-renationalised>

<sup>5</sup> Rail, '70% want end to privatisation' 13/09/2012. Available at <http://www.rail.co/2012/09/13/70-want-end-to-rail-privatisation/>

<sup>6</sup> Virgin Trains, 'Virgin Trains Limited commences Court proceedings in respect of West Coast Main Line franchise award' 28/08/2012. Available at <http://mediaroom.virgintrains.co.uk/2012/08/virgin-trains-limited-commences-court.html>

passenger satisfaction plus ‘efficiency equivalent to that achieved by the best comparable railway in the world’.

A casual reader of broadsheet newspapers must realise we are well short of that goal. The most recent and quasi-official efficiency comparisons appeared in the McNulty Report of May 2011 for the DfT. *The Financial Times*’ reporter wrote that McNulty had found ‘the average train cost 40% more to run in the UK than on some European comparable railways’.<sup>7</sup> But the media commentary did not focus on the reasons for the efficiency gap, nor raise the larger question of how inefficiency related to other problems. And matters have since been confused by the debacle in autumn 2012 about the rescinding of the award of a 15 year franchise on the West Coast line to FirstGroup. In this case, civil servants got their maths wrong when evaluating competing bids. And the outcome was a two year extension to the existing franchisee, Virgin Trains while two independent inquiries led by businessmen would make recommendations so that the DfT could get the franchise competition back on track.

In understanding all this, we draw on John Maynard Keynes who is now mainly remembered as the author of the *General Theory* and as a major architect of the Breton Woods settlement. Instead we focus on Keynes 1919 book on *The Economic Consequences of the Peace* which is about how the European delegates bamboozled US President Woodrow Wilson over the terms of the Versailles treaty and Keynes’ attempt to debamboozle his readers about harsh treaty reparations which he foresaw would stoke German *revanchism*. Keynes framing of his argument depends on two key insights. First, the bamboozling works as the sharp witted European politicians play on the hopes for a better world of a ‘generously intentioned’ US President who is at each stage convinced that unjust terms are consonant with his high principles. Second, what Keynes called ‘debamboozling’ is difficult because of this psychological investment which in the case of President Wilson was related to his ‘theological temperament’. Keynes’ tactic is then to convince the reader about harsh and unfair terms by piling up the empirics and presenting political arithmetic about Germany’s limited capacity to pay reparations on the scale demanded by the Treaty.

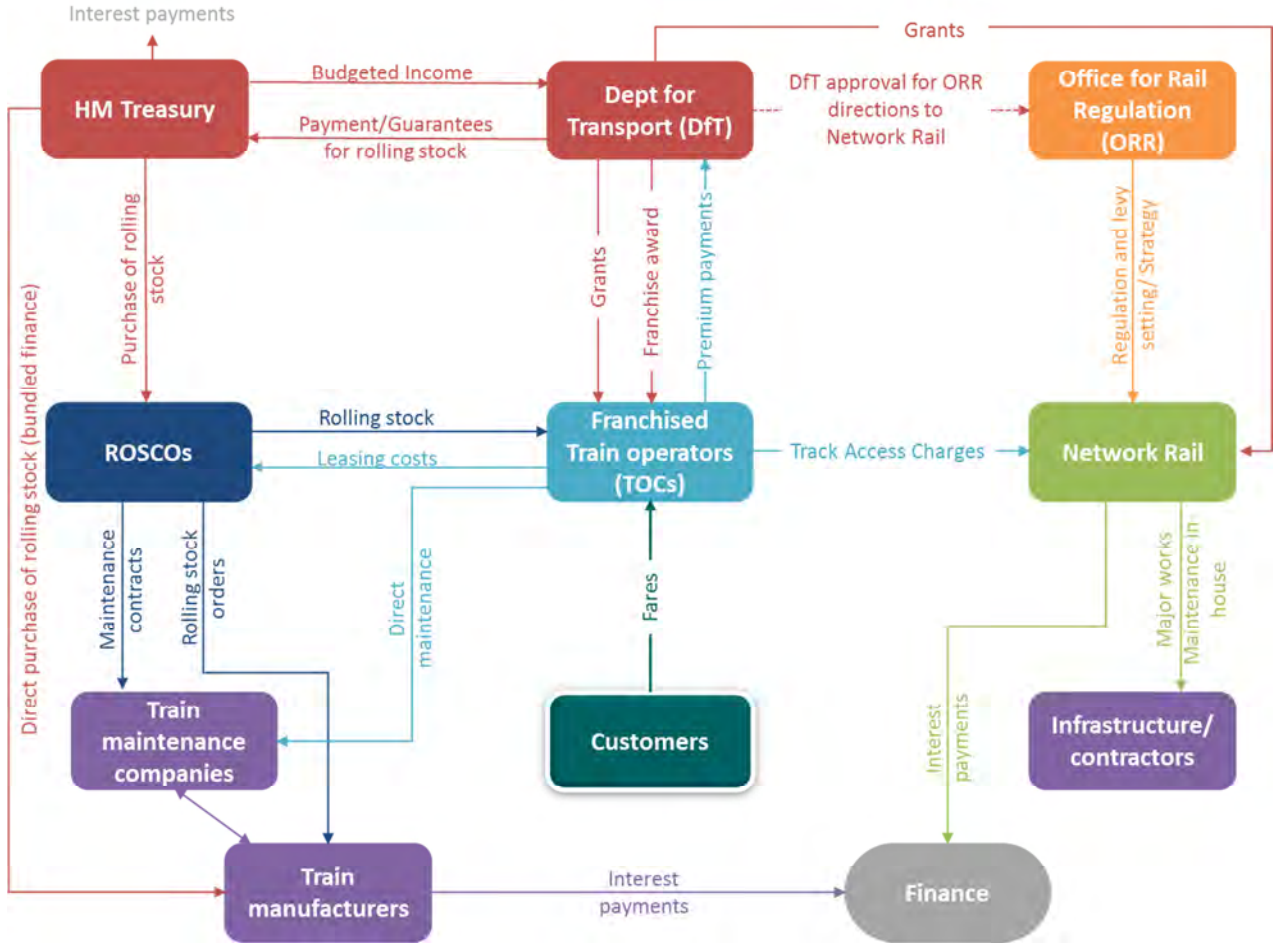
Much of this can be transposed to our understanding of rail privatisation. First, the privatisation of rail was floated on a tide of political promises, which encouraged well intentioned public hopes about how privatisation was a generic formula which could, through enterprise and management, transform every sector of the economy (including rail). Second, the debamboozling requires detailed empirics and much political arithmetic through which the reader can understand mechanisms, limits and consequences. It is fairly easy to show in our first chapter that public hopes for more private investment and less public subsidy were disappointed. But we then require five chapters of forensic analysis to present a comprehensive overview of outcomes and consequences.

The outcomes are complex because the Major government through the 1993 Railways Act decided on a disintegrated, tripartite structure for the privatised rail industry and completely ignored sector-specific problems, which would make it unworkable. A stock market quoted PLC (initially Railtrack) was to be responsible for infrastructure, train operating companies (TOCs) would bid for franchises to run trains with rolling stock (the industry term for the train engines and carriages) leased from

<sup>7</sup> Financial Times, ‘Move to cut rail travel costs by up to 30%’ 19/05/2011. Available at <http://www.ft.com/cms/s/0/157c1f9e-8206-11e0-a063-00144feabdc0.html>

rolling stock operating companies (ROSCOs). After the collapse of Railtrack, the infrastructure was taken over by not for dividend Network Rail and the current structure is presented below in simplified form.

**Exhibit 1: Current structure of the rail network**



The two- fold cost recovery problems of the rail sector were ignored. First, as the academic accountant Jean Shaoul has incisively argued, there was never enough fare and freight revenue in the rail system to meet operating expense, capital investment and the claims of shareholders in both the infrastructure PLC and train operating companies; second, operations were complicated because the revenue line in railways is much more uncertain when passenger numbers are cyclical, even if they increase in the long term with economic growth.<sup>8</sup>

These undisclosed realities ensured that, one way or another, everybody was not going to live happily afterwards, simply because the trains could not be kept running on a modernised, privatised system without increased state subsidy. The post 1997 system had inherent problems which were brought to a head by the management ineptitude of the privatised infrastructure company, Railtrack, which outsourced everything, lost control of rail safety, panicked into implementing widespread speed restrictions after the October 2000 Hatfield rail disaster, and then failed financially shortly afterwards. New Labour replaced the PLC with a not for dividend company

<sup>8</sup> Shaoul, J. (2007) 'Leasing passenger trains: the British experience' *Transport Reviews*, 27(2), pp. 189-212; Shaoul, J. (2006) 'The cost of operating Britain's privatized railways' *Public Money and Management*, 26(3), pp. 151-8.

called Network Rail and, in effect, used state guarantees on Network Rail borrowings and large government grants to fund infrastructure investment. After this, the story gets quite complicated which is why we need a long report.

## **TOCs, franchises and the political construction of profit**

In telling the story of privatised rail, we concentrate on the TOCs for two reasons. First, as we will argue, the TOCs are engaged in a very peculiar kind of business, which is about positioning so as to limit risk and maximise the ability to extract value. Second, the TOCs are in politics not economics because they operate in a space where profits are politically constructed and they have become the central political players who now define the reform agenda. The background is that privatisation created a peculiar ‘fee for service’ business so that the TOCs are quite unlike an ordinary capitalist firm using capital and labour to make and sell goods and services. The TOC bids for a limited-life franchise during which it will receive forms of direct and indirect subsidy and protection from risk, while making ‘premium payments’ as a kind of rent to the state; TOCs invest very little capital because infrastructure is provided in return for track access charges and rolling stock is rented from a leasing company; the TOC is usually a special purpose vehicle (SPV) subsidiary, wholly owned by a large corporate parent and the standard practice is to remit all surplus in the form of earned profits as dividends to the parent who takes limited responsibility for SPV losses.

The profit and dividends could be construed as a kind of fee for service, which raises two questions. First, and fundamentally, what is the corporate owner’s contribution or added value that justifies the taking of any fee? The question is relevant because trains could of course be directly operated by labour and management; and, as we shall see in chapter six, the East Coast Main Line is run by the government’s Directly Operated Rail and performs well without any corporate parent. Second, and more pressingly, there is something very odd about a fee for service system, which works by giving TOCs the option to distribute profits while also sheltering them from losses. This is a publicly subsidised industry which would be massively loss making if it were vertically integrated and financially consolidated as British Railways PLC. The TOC profits are not earned in the market but politically fabricated out of regulatory confusion, political expediency and predatory contracts which creates profitable positions in a loss making industry where more profits for the TOCs equals bigger losses elsewhere. We demonstrate this point below with some exhibits taken from the body of our report.

Exhibit 2 provides a comparison between net profit and direct subsidy for five TOCs, those that currently receive the largest direct public subsidy, over five years. For example, a figure of 6.1% means that the net profit for the year is equivalent to 6.1% of the direct subsidy. A negative sign means that the TOC made a loss in that year. It is clear that the profitability varies considerably between the TOCs, as well as over time. Taking these five TOCs together net profits are equivalent to anything between 6.1% and 31.3% of direct subsidy, depending on the year; over five years the aggregate net profit was equivalent to 9.9% of the direct subsidy. Exhibit 3 indicates how much of the profit is distributed as dividends for these same TOCs. Again, there are differences between years in each of the TOCs. But overall, some 92.4% of the net profit has been distributed as dividends between 2007 and 2011.

**Exhibit 2: Net profits as a proportion of direct State subsidies to TOCs for the top five recipients of public subsidy 2007-2011<sup>9</sup>**

Net profit as a share of the State's direct subsidy						
	Arriva Trains Wales	First Scotrail	First TransPennine	Northern Rail	Southeastern <sup>10</sup>	Top 5 subsidised TOCs
Total 2007-2011 <sup>11</sup>	8.3%	6.1%	31.3%	6.2%	11.7%	9.9%
Total direct TOC subsidy 2007-2011	£719.4m	£1,378.3m	£535.1m	£1,779.4m	£703.5m	£5,115.8m
Total TOC net profit 2007-2011	£59.4m	£84.3m	£167.4m	£110.5m	£82.4m	£504.1m

**Exhibit 3: Dividends as a proportion of TOCs net profit for the top five recipients of public subsidy 2007-2011<sup>8</sup>**

Dividends as a share of net profit						
	Arriva Trains Wales	First Scotrail	First TransPennine	Northern Rail	Southeastern	Top 5 subsidised
Total 2007-2011	99.4%	98.4%	83.6%	105.9%	81.3%	92.4%
Total TOC net profit 2007-2011	£59.4m	£84.3m	£167.4m	£110.5m	£82.4m	£504.1m
Total TOC dividends 2007-2011	£59.0m	£83.0m	£140.0m	£117.0m	£67.0m	£466.0m

The TOCs are profitable because they receive both direct and indirect public subsidy (the latter arising from government funding of Network Rail, which is explained below). As exhibit 2 and 3

<sup>9</sup> Sources: Annual report and accounts, Fame, BvD and Office for Rail Regulation (ORR). The accounting data relates to financial year and subsidy data is the net figure after accounting for premium payments. The data is from ORR's mid-year audit. Nominal data.

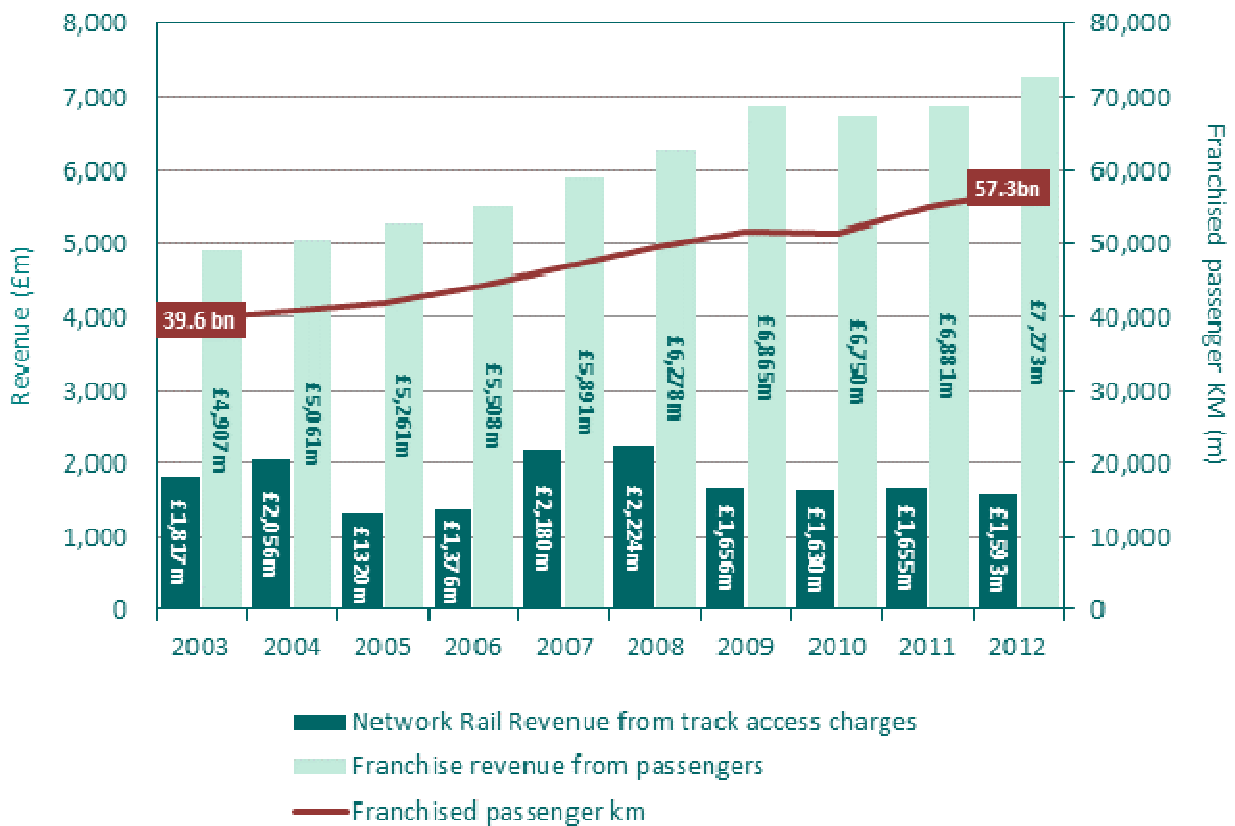
<sup>10</sup> Direct subsidy is estimated from ORR data as the TOC, London & Southeastern Limited does not separately publish State derived income.

<sup>11</sup> The total 2007-2011 figure for net profit as a percentage of subsidy is not the arithmetic sum of the individual year's percent. It is the net profit over the five years divided by the total direct subsidy, and cannot be calculated by adding the percent figures for the individual years because the subsidy varies by year.

show, the results are obviously paradoxical in the case of those TOCs which are only profitable because they receive large direct public subsidies, but are in effect then able to distribute this as private dividends. In this case, it would clearly be more sensible for the state to dispense with the fiction of TOC profit and bargain explicitly on what kind of fee for which services. The picture is even more curious if we look at how indirect and undisclosed subsidy creates the possibility of TOC profitability in the rail sector. If one of the key problems of privatised rail was not enough revenue in the system, this was immediately resolved after the collapse of Railtrack. Under Network Rail, track access charges have been held down to create a huge indirect subsidy of TOC profits paid for out of public funds. Low track access charges reduce Network Rail’s receipts from the TOCs and the revenue shortfall is then made good either by the injection of public funds (called the Network Grant), or by public guarantee of Network Rail’s increased private borrowings which fund capital expenditure.

As exhibit 4 shows, passenger numbers have increased by some 50% since 2003 and passenger fares revenue for the TOCs has increased by almost as much; meanwhile, Network Rail’s revenue from track access charges has actually declined in real terms from £1.7 to £1.6 billion. It is quite bizarre that this regime is almost never publicly discussed, and is disclosed only in obscurely technical official documents.

**Exhibit 4: Comparison of Network Rail revenue, franchised TOC revenue from passengers and franchise TOC passenger km travelled (All financial data in 2012 prices)<sup>12</sup>**

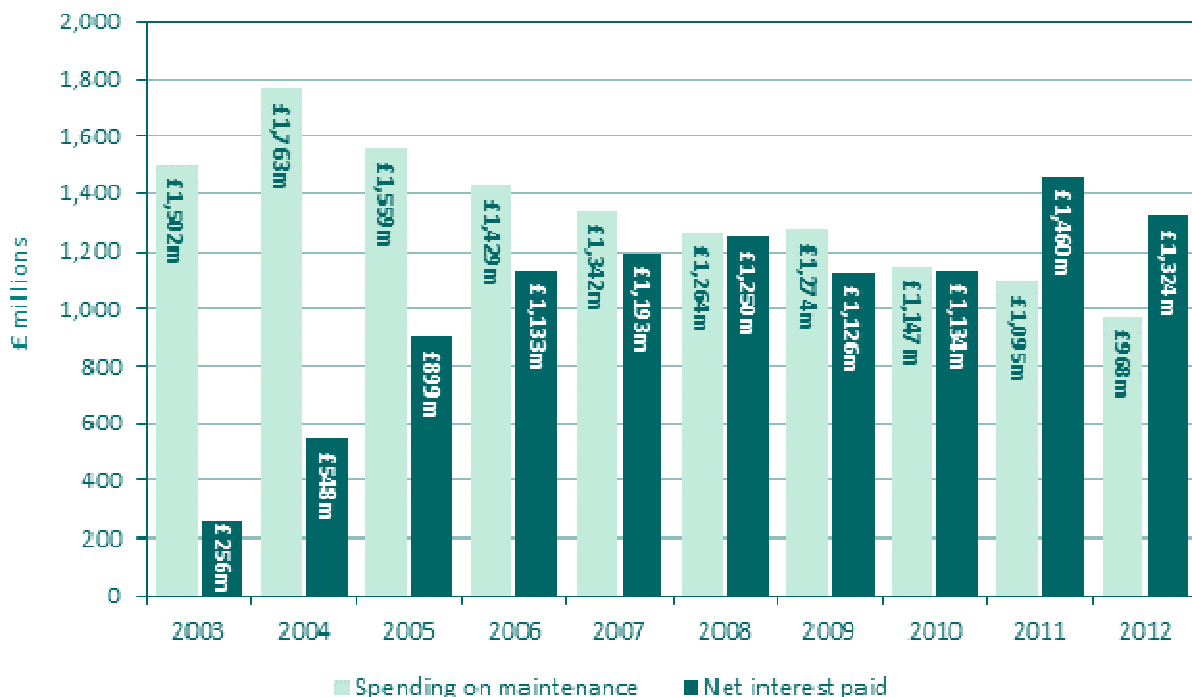


<sup>12</sup> Source: Regulatory accounts and ORR National Rail Trends.

Consequently, TOCs are allowed to declare operating profits and even claim that private enterprise is reducing public subsidy which is true if we consider direct subsidy only. But the key undisclosed pre-condition of TOC's profit is the fudge whereby the sector's operating loss and its capital expenditure charge is, in effect, being charged to the not for profit, quasi-public part of the sector – Network Rail which indirectly subsidises the TOCs via low track access charges. This should be a matter of major public concern because of course the outcome is not less subsidy but the undisclosed shuffling of a large subsidy, which has major consequences. The subsidy shuffling only flatters the TOCs and postpones the problem as (publicly guaranteed) debt accumulates in Network Rail's balance sheet and the sector in effect acquires another private sector stakeholder in the form of the Network Rail debt holders, unless and until the state writes the debt off.

This is now an urgent but politically unacknowledged and publicly un-discussed issue because, after a decade of subsidy shuffling Network Rail's accumulated debt and our public liability) is nearly £30 billion<sup>13</sup> which is mainly £28 billion recently issued long-term debt. In consequence as exhibit 5 shows, Network Rail is already spending substantially more on interest payments to outside debt holders than it is on maintenance within the rail system. And this will get worse not better as the outstanding debt will hugely increase when Network Rail implements plans for £38 billion of capital investment over the next five years.<sup>14</sup>

**Exhibit 5: Network Rail's spending on infrastructure maintenance compared to net interest paid<sup>15</sup>**  
(£m, 2012 prices)



The other major issue is the division of risk and reward between the state and the TOCs. This is important in a sector where revenue is uncertain and franchise bids must make assumptions about

<sup>13</sup> Network Rail's bank debt and loans in 2003 was £1.4bn and in 2012 the total was £29.4bn. (Source: Annual report and accounts).

<sup>14</sup> RAIL, issue no. 714, January 23-February 5, 2013, p.6-7.

<sup>15</sup> Network Rail regulatory accounts, various years.

passenger numbers over periods of up to ten years or more. The division of risk and reward is inequitable because the franchise contract gives every TOC the chance of reward through an option to distribute profits, while the downside risk is limited because, if substantial operating losses are in prospect, the franchisee can either receive revenue support from the state, or walk away after paying a modest penalty and leave the state to run the trains.

Matters are further complicated by the state's failure to address a tendering process which encourages overbidding for franchises on terms which allow TOCs to distribute profits in the early years of a franchise and then walk away. As we have already noted, the successful bidder promises to compensate the state with 'payments premiums'. But there are no rules to require the payment of a minimum proportion of all premiums in the first half of a ten-year contract; nor any serious deterrent in the form of a large financial penalty for handing back the franchise in mid contract. Consequently over bidding is encouraged in a process where the bidder can back load 'payments premiums' into the later years of a ten year franchise and clear profits off the table in the early years. If the over optimistic passenger number and revenue projections do not materialise, there is then an option to walk away and avoid large premium payments due in later years while paying a break penalty which is small in relation to profits which have been already taken and will not be clawed back.

As exhibit 6 shows, the FirstGroup bid for the West Coast Main line (which failed on a technicality in 2012 before First Group took it up) has the same premium bid profile as three previously successful bids (which quickly went wrong when the trains started running). The graph shows that the premiums paid by the TOC increase steeply over the life of the franchise from around zero in all cases in the first year. In these three earlier cases, the franchisees walked away mid-franchise after promising large payment premiums in the later years of the contract which they avoided by their timely exit. Any termination of the franchise before its contractual end means that it will turn out to be worse value for money for the public sector than originally estimated because the total premium payments made by the TOC will be less than expected. Given the steep rise in annual payments in the profiles shown in exhibit 6, even walking away half way through the franchise will mean that a great deal more than half the payments are not made by the franchisee. It is quite outrageous that the DfT continues to acquiesce in back loading despite the accumulated evidence that it is against the public interest. This is not an openly debated issue because bid profiles are not generally publicly disclosed. Consequently, there cannot be any informed public discussion of whether bidders who back load premium payments should be disqualified from future franchise bids or suffer large walk away penalties.<sup>16</sup>

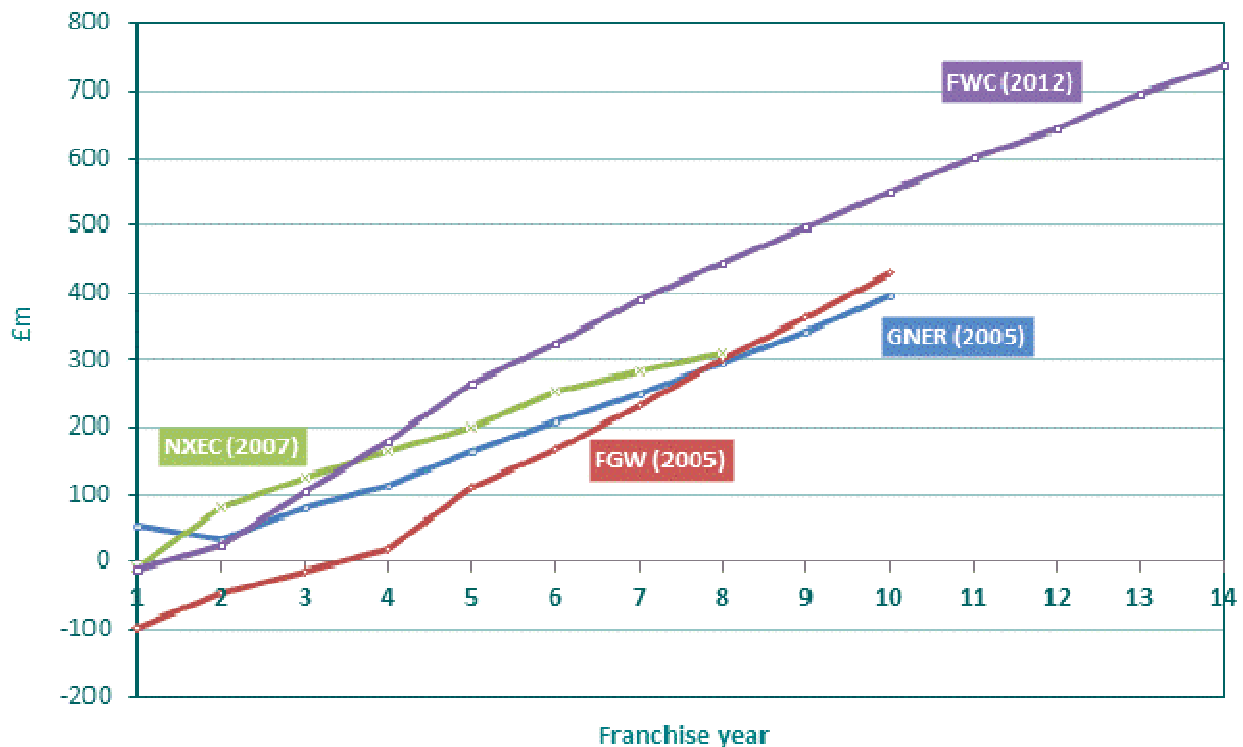
How should we understand these economic behaviours and the broader consequences? In the rail sector, the contracting state is running a very peculiar kind of casino where the odds are rigged in favour of the corporate punters and against the house. As we shall see, it is not the case that all TOCs win, but a franchised TOC can never lose much as long as the state carries the risk; and all of this is guaranteed by contract. This has been the private understanding of dissident insiders for more than a decade. Consider the case of one former banker, Shriti Vadera, who became a special adviser and then junior Treasury minister for New Labour. In an internal Treasury email of August

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<sup>16</sup> Significantly, bid premium profiles are disclosed to investment analysts and that is how we obtained much of our information.

2001 (only subsequently disclosed as part of a legal action), Vadera pithily described the TOCs as ‘thinly capitalized, equity profiteers of the worst kind’.<sup>17</sup>

**Exhibit 6: Comparison of premium profiles in failed franchises**<sup>18</sup>



But, in official reports, notably the major 2011 *Rail Value for Money* report by Roy McNulty, the high costs of the franchising system are framed as the result of ‘fragmentation’, ‘transaction costs’ and ‘wrong incentives’ which are all *passive* processes consequent upon system mis-design.<sup>19</sup> In our view, the problem of the franchising system is that it can lead to an *active* process of value extraction at the expense of the taxpayer by opportunist private players in a habitat where competitive strategy is not focused on service or production but on positioning. We call this *contractualism* because the means of value extraction is the private firm’s contract with the state. The contract consistently disadvantages the state, partly because the private firm has more expertise and mainly because the state’s pursuit of ‘value for money’ is undermined both by its determination to keep the franchise system going and by the complete inability to think of an alternative.

The behaviour here overlaps with but is not the same as that of ‘rent seeking’ in mainstream economics. Rent-seeking is defined by the absence of discipline arising from the abridgement of *competition in the market* through monopoly or the manipulation of government and regulation. In the case of rail privatisation, the private sector was gifted a form of *competition for the market*

<sup>17</sup> HM Treasury (2001), ‘Email - re: Ariel’. Available at <http://www.railwaysarchive.co.uk/docsummary.php?docID=137>

<sup>18</sup> Sources: Morgan Stanley, Company Data, DfT, Roger Ford) (Cash or NPV). Notes: FGW is First Greater Western; GNER is Great North East Railways; NXEC is National Express East Coast; FWC is First West Coast.

<sup>19</sup> McNulty, R. *et al.*, (2011) *Realising the Potential of GB Rail: Final Independent Report of the Rail Value for Money Study*. Available at <http://www.rail-reg.gov.uk/upload/pdf/rail-vm-detailed-report-may11.pdf>

which, thanks to the confusions of regulators and government, provided a nearly ideal habitat for value extraction in a world where all giant companies need to deliver shareholder value.<sup>20</sup> The fundamental precondition of value extraction is not the absence of the market but the presence of an imagined world that credits private firms with generic transformational qualities, which can deliver efficiency.

It is important here to add the explicit qualification that we are not protesting against subsidy per se but against uncontrolled (and often undisclosed) subsidy which enriches private interests for no good social purpose. There is a clear difference between principled corporate welfare for firms that provide a socially valuable service in an appropriate way, and predatory corporate looting of the state by railway or other companies. Corporate welfare for private firms is, like social security for the masses, an entirely legitimate object of policy. As Farnsworth argues, we should not object to the considered and temporary use of state funds to support small start-ups or mature firms in need of restructuring. The growth of new firms and the orderly decline of mature firms can contribute to the public good in a complex economy, which is not best served by putting everything on the market.<sup>21</sup> And it is therefore encouraging to see that some kind of activist industrial policy is back on the policy agenda in the UK.

But the process and outcomes in rail franchising are completely different. As we demonstrate in this report, the beneficiaries who control the franchise companies are neither small nor weak because they are either subsidiaries of European state-owned rail operators,<sup>22</sup> large multinational transport conglomerates like Stagecoach, which grew out of UK bus privatisation, or influential facilitators of outsourcing like Serco. The financial assistance afforded to them is indefinite rather than temporary, and it is quite impossible to discern the social good arising from such support. Social welfare reformers could usefully turn from their project of rolling back benefit support for supposedly dependent and undeserving individuals and focus on value extraction by undoubtedly dependent and underserving corporates.

## The (second) Great Train Robbery and its political consequences

The metaphor of train robbery provides us with an analogy and dis-analogy. In the first great train robbery of August 1963, a gang of South London criminals robbed the Royal Mail by stopping the Glasgow to London mail train, coshing the driver and then in a human chain passing some £2.5m in cash from the High Value Packages carriage into a waiting truck. The second great train robbery, as described in this report, is about companies that managed a bigger heist of public funds by running trains up and down the lines after rail privatisation. The 1993 Railways Act created a new structure with opportunities for positioning by train operating and rolling stock companies who could quite legally distribute (direct and indirect) state subsidy to benefit their owners.

<sup>20</sup> McCartney, S. and Stittle, J. (2011) 'Carry On up the East Coast', *Public Money & Management*, vol.31 (2), pp.123-130.

<sup>21</sup> Farnsworth, K. (2012) *Social versus Corporate Welfare: Competing Needs and Interests within the Welfare State*. London: Palgrave Macmillan.

<sup>22</sup> Arriva is a wholly owned subsidiary of the German national rail company Deutsche Bahn, Keolis is majority owned by the French national rail operator SNCF, and Abellio is owned by the Dutch state operator Nederlandse Spoorwegen.

The analogy is a nice one because it brings out the important point that the proceeds of train robbery are in both cases fairly modest sums, which are nevertheless very attractive in terms of reward for effort. The £2.5 million stolen in 1963 had to be divided between more than 15 full gang members into individual shares of about £150,000 and, after inevitable deductions for safe keeping, none of the gang members (except possibly Gordon Goody) was set up for life; nevertheless, the full share was attractive in terms of reward for risk because the train gang member's share was much larger than the average smash and grab.

Much the same point could be made about the TOCs. The sum extracted as dividends in any one year is modest in relation to subsidy or operating revenue: as exhibit 7 shows, in 2011 the dividend amounted to a modest £160 million against public subsidy<sup>23</sup> of £2.5 billion and revenue of £7.6 billion.

**Exhibit 7:** DfT Franchised TOC turnover, total net subsidy<sup>24</sup>, net profit and dividends 2010-11<sup>25</sup>

	Total revenue £m	Total Subsidy (less premium payments) <sup>22</sup> £m	Net profit £m	Dividends £m
c2c	127.8	35.8	11.7	5.0
Chiltern Railways	128.8	58.3	-46.6	0.0
CrossCountry	387.2	322.6	-20.0	0.0
East Coast	664.6	20.6	5.1	0.0
East Midlands Trains	297.8	161.6	-19.8	0.0
First Capital Connect	497.7	-18.5	3.8	0.0
First Great Western	902.8	213.3	-41.9	0.0
First TransPennine	268.3	195.9	35.9	30.0
London Midland	325.4	204.5	-0.4	0.0
N.Express East Anglia	560.3	102.5	24.6	24.0
Northern Rail	570.6	428.1	27.6	27.6
Southeastern	719.3	462.8	18.3	11.0
Southern	611.0	88.8	15.7	2.5
South West Trains	746.0	82.0	35.2	30.0
Virgin Trains	797.2	129.3	39.9	30.0
DfT franchised TOCs	7,604.9	2,487.6	89.1	160.1

<sup>23</sup> Note: Subsidy *includes* the subsidy allocated to Network Rail which is in practice largely applied towards lowering track access charges for TOCs. See note below.

<sup>24</sup> Net subsidy is gross subsidy which includes fare subventions and performance payments, less premium payments.

<sup>25</sup> Sources: 'Costs and Revenue of Franchised Passenger Train Operators in the UK', ORR; 'Cost of running the rail network' DfT, <https://www.gov.uk/government/publications/cost-of-running-the-rail-network> Accessed 26-12-2012; Fame, BvD and Network Rail annual report and accounts.

Notes: The figures include access charges and performance regime payments. Net subsidy is calculated by taking total Network Grant and apportioning to each TOC according to its share of total fixed track access charges charged by Network Rail and deducting any premium payments.

In terms of corporate reward for risk, this is attractive because a train franchise involves an option on profits (with almost no capital required). This is well worth having if it comes good, as it did for Virgin, which has extracted around £500 million over more than ten years from the WCML.

**Exhibit 8:** DfT franchised TOC's net profit and dividends on turnover 2010-11<sup>26</sup>

	Net return on turnover %	Dividends return on turnover %
c2c	9.1	3.9
Chiltern Railways	-36.2	0.0
CrossCountry	-5.2	0.0
East Coast	0.8	0.0
East Midlands Trains	-6.7	0.0
First Capital Connect	0.8	0.0
First Great Western	-4.6	0.0
First TransPennine	13.4	11.2
London Midland	-0.1	0.0
N.Express East Anglia	4.4	4.3
Northern Rail	4.8	4.8
Southeastern	2.5	1.5
Southern	2.6	0.4
South West Trains	4.7	4.0
Virgin Trains	5.0	3.8
DfT franchised TOCs	1.2	2.1

At the same time, many TOCs do not make much profit and that £160 million of dividends in the aggregate is a modest fee for operating the UK's trains which amounts to no more than 2.1% of turnover<sup>27</sup> (exhibit 8). That implies that the rail sector is not being directly ruined by the extractions of the TOCs. For example, the overall subsidy requirement is not greatly increased by TOC deprecations, given the size and cost of the overall system. From the point of view of other stakeholders, rail fares probably would not be much lower and employee wages would not be much higher if the extraction were ended. But this takes place in a context where modest amounts of profit at a point can motivate corporate economic action and, in this case of a privatised system, the economic extraction then has secondary but much more important political consequences. The extraction sustains and animates the corporate and managerial actors who politically set the reform agenda and indirectly block any policy measures and attempt to discredit measures which do not suit existing private sector interests.

<sup>26</sup> Sources: FAME, BvD.

<sup>27</sup> Note, however, that this level of return results in quite a high return on capital employed (ROCE), as the *Financial Times* (1<sup>st</sup> Jan 2013) points out in a pro-franchise article. Returns on capital employed can be as high as 50-70%, according to an analyst cited (<http://www.ft.com/cms/s/0/354a7a90-505a-11e2-805c-00144feab49a.html#axzz2HTHdk2rO>), partly because the business is 'thinly capitalised' so that there is little capital at risk.

At this point, the Great Train Robbery becomes a disanalogy. The 1963 Great Train Robbery was seen by political authority in the Home Office as brazen criminality, which should be met with the full force of the law as Scotland Yard's finest thief takers were put onto the job of apprehending gang members and the judiciary enlisted in handing down exemplary punishment in the form of 30-year sentences. The second Great Train Robbery is seen by political authority in the DfT as a problem of misincentives, costs and inefficiencies, which can be fixed by putting senior TOC managers and others with management experience from the corporate sector in charge of reform. Tommy Butler, head of the Flying Squad in 1963, would no doubt be puzzled by the political logic of rail privatisation, which is to put the fox in charge of the hen coop.

The resulting official reform agenda is not one of abolishing dysfunctional franchising and the habitat of value extraction but of continually tinkering with an imperfect franchising system with the double aim of realising the original promises of privatisation and making the rail sector appear more like a micro economics text book (while preserving profit opportunities). Franchising was given a 'flawed in execution but fundamentally sound' verdict by McNulty's two year long *Rail Value for Money Study* and in the DfT's subsequent *Putting the Customer First* command paper (both discussed in greater detail in chapter 6) and in the Brown review of franchising published in early 2013. Previously, much the same line was taken in the National Audit Office's *Value for Money* report which said franchising was achieving better value for money under the DfT than the Strategic Rail Authority.<sup>28</sup>

This verdict fits with the official view of ATOC, which represents franchising as a means of delivering customer satisfaction while managing risk when it claims that 'for the Government, franchising offers a means of managing the financial risks of providing train services rather than running them directly itself'.<sup>29</sup> It also fits with the response of individual senior managers to the collapse of the West Coast Mainline franchising process and the suspension of all subsequent tenders. As Tim O'Toole, chief executive of FirstGroup PLC said in the *Financial Times* recently, 'This is an awfully traumatic thing not only to us but to the whole industry ... We as a group think the franchise system is in no way broken or needs no major overhaul.'<sup>30</sup>

The major recent official report on rail sector reform was the aforementioned *Rail Value for Money* study commissioned by the DfT and chaired by Roy McNulty. One of McNulty's key recommendations, subsequently adopted as government policy, was that rail franchises should become longer in duration (and therefore more speculative in their revenue projections) and more 'flexible' in their terms and conditions.<sup>31</sup> The hope was that the TOCs might then take a long-term

<sup>28</sup> The Strategic Rail Authority was set up to manage franchising by New Labour in 2001, before responsibility was handed to the DfT in 2001. McNulty, R et al (2011) *Realising the Potential of GB Rail*, Department for Transport (2012), *Reforming our Railways: Putting the Customer First*. Available at [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/4216/reforming-our-railways.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/4216/reforming-our-railways.pdf), and National Audit Office, *The Department for Transport - Letting Rail Franchises 2005-2007*. Available at [http://www.nao.org.uk/publications/0708/letting\\_rail\\_franchises.aspx](http://www.nao.org.uk/publications/0708/letting_rail_franchises.aspx).

<sup>29</sup> ATOC 'Franchising: ATOC's view'. Available at <http://www.aTOC.org/clientfiles/File/Policydocuments/Franchising2010.pdf>

<sup>30</sup> Financial Times, 'FirstGroup dividend pledge under threat' 07/11/2012. Available at <http://www.ft.com/cms/s/0/69ca39e0-28b9-11e2-9591-00144feabdc0.html>

<sup>31</sup> The late SRA had previously briefly attempted to set up 20 yearlong PPP SPVs, but only one was created – Chiltern Rail. Longer rail franchises in order to encourage investment is not a new idea to McNulty, it has been

interest in the health of the railways and (with more vertical integration) actually invest a bit more of their own money; the industry's broadly favourable response suggests they saw it as more opportunity for extraction.

The West Coast Mainline franchise competition of 2012 was the first post-McNulty 14 year franchise and it ended in debacle about civil service miscalculations of value and risk in the different bids for that franchise. But the headlines about DfT blunders were fundamentally a distraction from the undisclosed problems of franchising (as described in the paragraphs above). The debacle changed nothing because the DfT briefed Sam Laidlaw and Richard Brown to sort the mess so that franchising could resume. Richard Brown was explicitly tasked with producing recommendations for 'how to structure risk transfer between the Department and rail franchisees' in order to 'get the other franchise competitions back on track as soon as possible'.<sup>32</sup> And this is what he delivered, with a report front-ended with the statement, 'I share the Government's view ... that the rail industry works, and that there is no credible case for major structural change ... It is very important that the franchising programme is restarted as soon as possible.'<sup>33</sup> This allowed the Transport Secretary Patrick McLoughlin to say, 'The review has confirmed that Government's approach to rail franchising system is still the best way to secure the rail services for tax payers and fare payers alike'.<sup>34</sup> These inquiries have broken with pre-privatisation practice of drawing on independent expertise. They do not, for example, have an independent academic chair nor recruit industry experts like Christian Wolmar, or technical journalism specialists like Roger Ford. Instead, the inquiries rely on industry insiders like Richard Brown and those who have passed through the revolving door between public service and private sector utilities like Lord McNulty and Sam Laidlaw, who is currently Chief Executive of Centrica, the privatised utility whose retail arm is British Gas. Richard Brown is the archetype of a rail industry insider. He is currently chairman and formerly chief executive of Eurostar, having previously made his reputation by setting up the rail division of National Express after starting life as a British Rail manager.

There also can be no doubt that these inquiries are telling the DfT just what it wants to hear. Whitehall civil servants and the Westminster political classes are the co-dependents of the extractive corporates because public servants cannot see any alternative to privatisation and their success is conflated with that of the TOCs. Ministries like the DfT have lost their independent sectoral expertise about how the rail system works without gaining the ability to write contracts, which stop the private companies gaming the franchise system. Instead, the DfT has opted to add technical complexities which its civil servants struggle to understand and operate. The front bench politicians lack the political will to stop gaming because of their near theological commitment to

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batted around since almost the start of privatization, mentioned for example in the 2000 Labour ten year plan for transport. DfT (2000) 'Transport Ten Year Plan 2000. Available at [http://www.railwaysarchive.co.uk/documents/DTLR\\_10YearPlan.pdf](http://www.railwaysarchive.co.uk/documents/DTLR_10YearPlan.pdf)

<sup>32</sup> DfT (2012), 'Text of letter from the Secretary of State to Richard Brown 15 Oct 2012'. Available at <http://assets.dft.gov.uk/publications/richard-brown-20121015a/letter-to-richard-brown.pdf>

<sup>33</sup> DfT (2013), 'The Brown Review of the Rail Franchising Programme'. Available at <https://www.gov.uk/government/publications/the-brown-review-of-the-rail-franchising-programme>

<sup>34</sup> DfT (2013), 'Press release: Government's rail strategy receives independent endorsement'. Available at <http://pressreleases.dft.gov.uk/Press-Releases/Government-s-rail-strategy-receives-independent-endorsement-685d8.aspx>

privatisation and outsourcing. The political classes endorse the management insider's agenda of "making franchising work better" and doing nothing which would upset the TOCs.

## **Reform (for a future that is not like the past)**

The starting point for effective reform has to be the abolition of franchising and facing up to the issue of Network Rail's accumulated debt as a public rather than private liability. After this initial step, we then have to be analytical about the sector-specific problems of cost recovery in rail if we want a future that is different from the investment-starved past.

The franchise companies should be removed from the rail system. The first most important thing is to abolish the political construction of profit which then motivates the sharp-elbowed corporates to frame and limit the reform agenda. The TOCs could immediately be replaced by a variety of organisational arrangements: by a publicly owned replacement for Network Rail or an extension of the existing direct operation by the state which already runs the East Coast main line; or (less desirably) by an explicit fee for service arrangement which, if set low, would attract employee owned or other not-for dividend organisations. But, one of the central messages of our report is that evicting the TOCs is not enough. It will only deliver the desirable social benefits of wholesale reform of the rail system if combined with a package of other reforms and a reframing of the whole problem of rail which focuses on sector specifics.

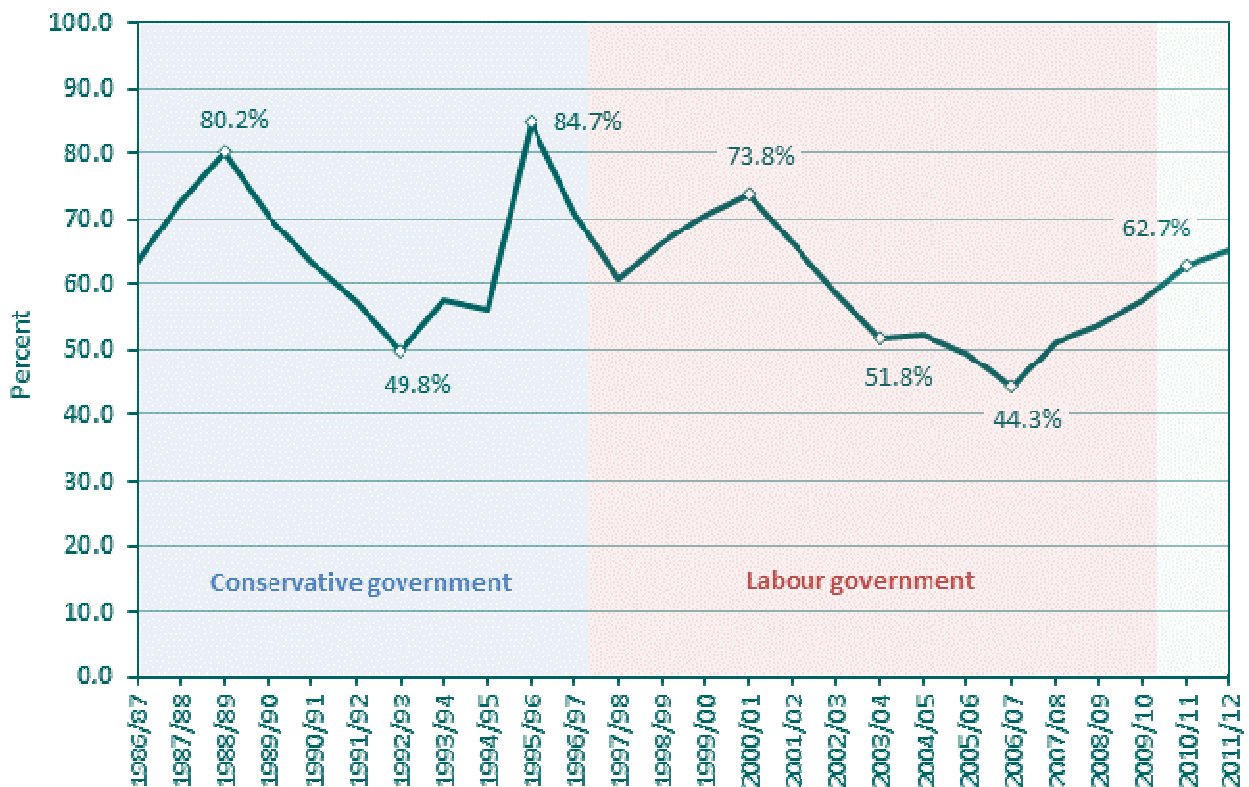
To this end, the political classes in Westminster need to face up to the consequences of their subsidy shuffling which has wrecked Network Rail's balance sheet, burdened the firm with debts it can never repay. There is no alternative here to the big write off of Network Rail's debts which will be painful because this is publicly guaranteed debt and some £30 billion has to be repaid to banks and private bond holders. The two options are either to write off Network Rail's debt by charging it against current public expenditure; or to convert the (off balance sheet, publicly guaranteed) Network Rail debt into (on balance sheet) public debt. But, even then, once and for all writing off of National Rail debt is not enough. Whatever the subsequent model of organisation and ownership that replaces franchising, subsidy shuffling should be abolished with all subsidy made direct and explicit.

As we argue later in this report, European examples of publicly owned rail systems show that other ways of organising rail can deliver better value for money (in terms of fares charged and subsidy required). Equally, as we note in our historical chapter, historians like Terry Gourvish have demonstrated, British Rail achieved decent levels of operating efficiency by the later 1980s. But a simple change in ownership alone cannot solve the problems of the rail industry which has unsolved sector specific problems about cost recovery, which go back to the nineteenth century and have persisted through several changes of ownership. British Rail's operating efficiency was partly the result of subsidy rationing and investment starvation which was symptomatic of a larger business model problem about cost recovery, which persists regardless of ownership.

If we take the network as a whole, it is impossible to recover all costs (of operating plus new investment), leave alone turn a profit from the revenues generated by charging passenger fares and freight tariffs; the problem of the cost recovery deficit is then greatly complicated by cyclicity, the uneven requirement for subsidy across the network and the need for lumpy new investment. The

basic secular problem of cost recovery is illustrated by exhibit 9 below which focuses on passenger fares which are much larger than freight charges. In the latter days of British Rail (with exemplary operating efficiency and capital starvation) passenger revenue never accounted for more than 80-85% of total income in the best years and no more than half in a bad year at the trough of recession. After privatisation, the curve shifts downwards so that the passenger fares account for 45-75% of all income depending on the year; the government's current target of raising the percentage to a steady 75% is only credible if fares are massively hiked (because cyclical volatility cannot be abolished and large parts of the network cannot be closed).

**Exhibit 9:** Passenger revenue as a share of total passenger revenue and grants<sup>35</sup>



It is therefore necessary in the concluding pages of this report to engage these sector specific problems after accepting that changing ownership is not enough. The TOCs and ROSCOs are the wrong form of ownership because they economically embed value extraction and politically limit reform. But there is no right form of ownership (public or private) unless and until the problems of cost recovery on the railways are confronted; because the corollary of cost recovery problems is capital investment starvation under public or private ownership. Equally it is not sensible to suppose that we can bracket questions of ownership and get infrastructural investment through the

<sup>35</sup> Sources: ORR and SN/SG/617, House of Commons.

Notes: Railtrack included maintenance expenditure as a capital item whereas BR counted it as current spend

Investment: 2001/02-2003/04 includes £3.520bn government grants directly to Railtrack/Network Rail and London & Continental Railways.

Total includes non-franchised passenger revenue (£36.7 in 2009/10 and £45.5 in 2010/11) and excludes freight revenue and subsidy.

Passenger revenue includes all ticket revenue and miscellaneous charges associated with passenger travel on national railways, e.g. car parking charges. For tickets involving travel on London Transport, receipts have been apportioned. Passenger revenue does not include government support or grants.

fix of private finance with state guarantees of return. That wheeze has already been tried in rail where its limits are now obvious as uncontrolled public liabilities accumulate. Network Rail is a warning about how private finance delivers some facilities at the expense of accumulating problems for the taxpayer because private capital becomes a new stakeholder with priority claims on subsidy and revenue, which effectively crowds out social objectives.

On this point, the business historians whose work is summarised in chapter 7 provide context which is helpful, partly because they are not radicals and do operate within a fairly orthodox economic framework. Mitchell *et al.* argue that the low profits in nineteenth century railways were not an indication of mis-allocation of capital but of a sectoral gap between low private returns to rail companies (from fares) and high social returns to society (from shorter journey times, increased land prices and general facilitation of urban, industrial development). Hence the need to consider fundamental issues above and beyond ownership and discuss policies which will be unfamiliar to most of our readers. For example, could some form of land value tax be used to tap the diffuse social gains from railways and create an investment fund that is otherwise not available?

Such fundamental rethinking is challenging. It is only necessary and justifiable when the existing system has failed completely. Hence, the importance of our empirically supported argument in the first seven chapters of this report that privatised rail is both omni-shambles and serial shambles which builds new complications on the basis of earlier unsolved and undisclosed contradictions which have a prehistory that goes back before rail privatisation through rail nationalisation to the mid nineteenth century.

## The Charge Sheet

The aim of this report is to bring the shambles of the privatised railway system into plain sight because that is the prerequisite for democratic political discussion of alternatives. After reading this report, a reader without accounting qualifications should be able to understand how the train operating companies (TOCs) get a great deal at the state's expense as they pocket politically constructed profits; while the sectoral problems arising from inadequate cost recovery are charged to the tax payer through the Network Rail balance sheet. A simple, intelligible mode of exposition is necessary and we have therefore adopted a charge sheet approach over some six chapters. The offence is the gap between the promises and the outcomes of rail privatisation, the charges then detail the behaviours by private companies and government, which license value extraction by predatory contractualism and private domination of the subsequent reform process without regard for the public interest.

We adopt this approach because it makes for an argument, which is both relatively easy to follow (especially given the complexity of rail) and robust if challenged. To make things easier to follow we have stripped away much detail about institutions of regulation and planning, like New Labour's Strategic Rail Authority or the Office of Rail Regulation which are only dealt with *en passant* as we tell the story of how the money flowed around the system. Like earlier independent researchers into rail, we are frustrated by complexity and limited disclosure.<sup>36</sup> We cannot be sure that we are correct about every detail of our forensic accounting; though we have buttressed our own quality

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<sup>36</sup> Shaoul, J. (2007) 'Leasing passenger trains' and (2006) 'The cost of operating Britain's privatized railways'

checks by retaining expert academics as pre- publication readers of this report. But the form of the argument is such that we hope the reader will at the end of this report endorse our verdict and finds the railway companies guilty as charged on a majority of counts.

## Charge sheet

### **Offence: Rail privatisation was politically sponsored with promises that have disappointed.**

The promise was that rail privatisation would deliver a better, cheaper service for rail users and tax payers. It was expected that private rail companies would bring in capital and innovate in ways that incidentally reduced public subsidy, because they were credited with generic enterprise characteristics and the capacity to transform any sector.

The outcome is disappointment because the privatised rail system requires more taxpayer subsidy, charges higher fares and has negligible private investment in ageing infrastructure and rolling stock with few improvements that can be un-ambiguously attributed to the private sector.

### **Charge 1: Privatisation created a habitat for value extraction at the public expense where (a) the TOCs play heads they win/tails we lose and (b) the ROSCOs find that every ticket wins.**

The sector-wide result of rail privatisation is a habitat within which risk and/or investment averse private companies position themselves as *value extractors* who claim cash which comes indirectly from high public subsidies (with government taking the operating risk and supplying investment funds).

A train franchise is not a license to print money because the TOCs have variable results in terms of profitability. But franchise bidders are attracted by a (low or no investment cost) option on upside profits with most of the downside risk passed to the state under a game whose rules for the taxpayer are 'heads they win and tails we lose'.

The ROSCOs do deliver a trickle of investment at state expense and at a high price under a lottery where 'every ticket wins'. Their high profits at no risk come through a value extraction process that has led to a decade of public criticism but only very modest reform.

### **Charge 2: Network Rail enables the charade by low track access charges which depend on public subsidy**

Network Rail has lowered its track access charges in an opaque, politically led process that provides an undisclosed indirect subsidy to prop up the TOCs' profitability and stores up problems in the form of £30 billion accumulated publicly guaranteed debt on the Network Rail balance sheet.

Infrastructural investment in rail is being publicly funded; while the TOC contribution to operating costs through track access charges have been falling even as they use the infrastructure more.

### **Charge 3: Franchising is predatory contractualism where unrealistic bidding which is against the public interest and generates a simulacrum of capitalism.**

Franchising can operate as predatory contractualism because the bidding process encourages corporates to game the system with optimistic projections of passenger numbers and back loaded premium payments. This rewards franchisees with easy profits in the early years and shifts risk onto the state because, when things go wrong, the train operators can walk away to avoid large premium payments.

The contracting state is a disaster in rail and the franchise system is unfixable because: (a) the DfT is in a relation of co-dependence with the corporates; (b) long term revenue streams are inherently unpredictable; and (c) maintaining the appearance of competition and markets requires low barriers to entry, and thus also to exit. The result is an economic simulacrum of capitalism which is politically resistant to reform.

### **Charge 4: The TOCs' public service defence is a farrago of half-truths**

As in other sectors, there is a trade association of TOCs whose role is partly to produce a misleading narrative about train operating as a public service. Specifically the TOCs claim credit for the increase in passenger numbers since privatisation and cite passenger surveys showing satisfaction with service punctuality and staff service.

But passenger numbers are a dependent variable (driven by GDP growth and other factors), as acknowledged in the new franchise revenue sharing mechanisms, while passenger surveys register the opinions of consumers of services and do not identify the public interest or recognise the public's view of how the railways should be owned and managed.

### **Charge 5: Government has avoided sector specifics by forgetting the pre 1948 history of privately owned railways and by making a straw man out of British Rail**

Post 1979 governments have forgotten the pre 1948 history of railways, under struggling private ownership, which highlights unsolved sector specific problems; nor have they learned anything from the British Rail period of public ownership, which is unreasonably stereotyped as awful failure.

The business historians and critical accountants studying British railways tell a cautionary academic tale about enduring sector specific problems of cost recovery and discrepancy between low private and high social returns. These expert accounts also tell us about how public ownership after 1948 was undermined by operating losses and under investment, which nevertheless finally produced operating efficiency.

### **Charge 6: Business led policy reviews and the official mentality are part of the railway problem not the solution**

Central government is part of the problem because policy since rail privatisation has taken the form of hurried improvisation and hyperactive reorganisation, which masquerades as rational reform while it delivers the next instalment of serial shambles.

So it is with the current regime change where a 2012 White Paper builds on the framing and recommendations of McNulty's business-led policy review. However, realigned incentives around new metrics for super TOCs and the break-up of Network Rail are very unlikely to deliver the projected efficiency savings.

## Chapter 1 – Promises of rail privatisation vs. outcomes

### Rail privatisation was politically sponsored with promises that have disappointed.

The promise was that rail privatisation would deliver a better, cheaper service for rail users and tax payers. It was expected that private rail companies would bring in capital and innovate in ways that incidentally reduced public subsidy, because they were credited with generic enterprise characteristics and the capacity to transform any sector.

The outcome is disappointment because the privatised rail system requires more taxpayer subsidy, charges higher fares and has negligible private investment in ageing infrastructure and rolling stock with few improvements that can be un-ambiguously attributed to the private sector.

In twentieth century British politics, large-scale changes of ownership were floated on hopes and promises of a better world. The projects of nationalisation and privatisation in successive generations were a matter of emotional attachment because they appealed to those who were dissatisfied with the world as it was and dared to hope that the generic formula of a change in ownership system would be transformative and deliver us from intractable messes. The promises of 1940s nationalisation are summed up in the black and white photographs of the Coal Board sign going up on vesting day in 1947: 'This colliery is now managed by the NCB on behalf of the people'. The promises of 1980s and 1990s privatisation are summed up in the short White Papers and the nearly interchangeable Hansard speeches of second rank Conservative ministers who listed the many benefits which privatisation would bring for all stakeholders in whatever utility was being privatised in the current parliamentary session.

The inevitable result in railways and other sectors was disappointment with outcomes because generic hopes snagged on sector specifics and ill-considered re-organisation. This chapter considers the promises made about rail privatisation in the period of privatisation around 1993; and the subsequent disappointing outcomes where the argument focuses on the two measurable fundamental issues of investment and subsidy. Rail privatisation promised to bring in more private investment and reduce public subsidy requirement but this did not happen.

## Promises

Re-privatisation of the railways had been an expressed desire of some Conservatives ever since the railways were nationalised at the end of the Second World War. The demands grew louder in the 1970s as British Rail and other nationalized industries were increasingly labelled (or stereotyped) as failed experiments. The Thatcher government began privatising public assets in the 1980s but the prime minister then rejected selling off the railways as a privatisation too far. Rail privatisation became a priority for the doomed John Major government, which did get the job done before the Conservatives were ejected from office in 1997 by the ascendant New Labour.

The July 1992 White Paper, *New Opportunities for the Railways* framed and justified the policy for rail with a series of assumptions and promises.<sup>37</sup> The Minister for Transport, John MacGregor, opened the paper by stating the assumption that privatization was a generic recipe for better services which would transform rail,

*Privatisation is one of the great success stories of this Government. It has taken different forms in different industries. But common to all privatisations has been the harnessing of the management skills, flair and entrepreneurial spirit of the private sector to provide better services for the public. The time has come to extend these benefits to the railways...*

This kind of *a priori* assumption about the benefits of railway privatisation has been subsequently maintained by government ministers of all parties over the past twenty years.

The 1992 White Paper also made more detailed promises about what (and how) privatized railways would achieve. In the ensuing 20 years these promises have been endlessly repeated and they have solidified into tropes, which now serve to confuse and conflate promise and outcome. The original 1992 White Paper claimed that privatisation would mean:

- ‘More concern for customer’s needs’ due to the incentive to attract custom.
- ‘Competition and ending the [British Rail] monopoly ... giving customers choice and stimulating improved services value’.
- ‘Management freedom’ with ‘less scope and justification for government involvement’.
- ‘Clear and enforceable quality standards’ which are written into contracts.
- ‘Motivation ... to reflect regional or local identities [and] boost the pride’ of employees.
- ‘Efficiency: smaller operating companies will bring more localised management closer to the public and greater opportunities to cut out waste and otherwise reduce costs, without sacrificing quality.’

When the promises are laid out like this, it becomes clear that they are less about the specifics of the rail sector and more about an imaginary of the supposed characteristics of generic competitive private enterprise, which can transform all sectors. One problem then is that the rail sector since its

<sup>37</sup> Secretary of State for Transport (1992), *New Opportunities for the Railways: The Privatization of British Rail*. Available at [http://www.railwaysarchive.co.uk/documents/DoT\\_WPO01.pdf](http://www.railwaysarchive.co.uk/documents/DoT_WPO01.pdf)

construction in the nineteenth century runs on quite different principles from the political imaginary of the 1990s and 2000s. It was never clear how the mechanisms of market competition plus management freedom could operate under its unique conditions.

Many of the original 1992 White Paper promises were strictly unrealisable in the rail sector (regardless of ownership): rail customers have rarely benefited from a choice of competing operators and customer choice cannot therefore compel train managers to raise standards; government has always had a major regulatory role in railways to ensure safety while broader government involvement in many other sectoral issues is one way or another inevitable when the post 1945 rail system has depended on public subsidy. Matters are further confused because improvements in some variables (like management motivation or enforcement of standards) could presumably be contrived under a variety of ownership regimes and the for-profit private sector has no monopoly on good governance.

If we focus on the more empirically realisable promises and try to take stock of our experience after twenty years, matters are still not straightforward. Some of the promises, like the one about private companies' 'concern for customer needs', raise complex conceptual and measurement issues. We will review evidence of customer satisfaction and public dissatisfaction in chapter 6, and at this point all we would say is that company success here depends on how stakeholders and their needs are defined in the first place.

But, there were and are two fundamental promises about the benefits of privatisation, which are amenable to straightforward measurement and empirical test against outcomes over the past twenty years. The first claim is that privatisation would reduce public spending on subsidy and costs to the taxpayer because private management would make cost savings and increase efficiency; the second claim is that privatised railways would attract large scale private investment, allowing modernisation of a kind which cash starved British Rail could never manage. John Major, who did not mention rail privatisation in his autobiography, was subsequently in 2008 asked to justify the policy of rail privatisation. His only positive argument was that rail privatisation would bring in investment funds because 'in the future - as in the past - no Government would ever provide the railways with adequate funding'.<sup>38</sup>

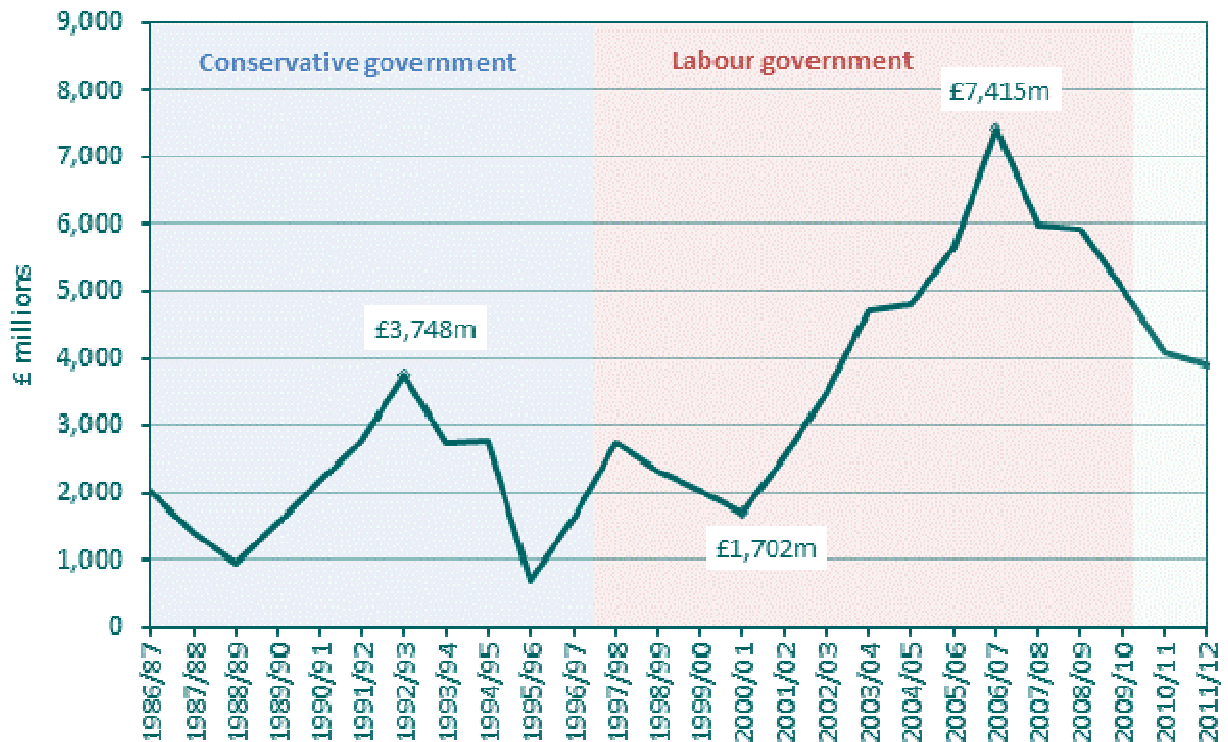
## Outcomes

On both fundamental promises, the empirical evidence is clear cut and shows the outcome of rail privatisation was seriously disappointing. As we have seen, calculations of subsidy at rail company level are complicated by the issue of indirect subsidy as funding circulates within the sector, but public expenditure accounts also give an incomplete overview of subsidy at rail sector level because the public accounts do not include any provision for public guarantees on Network Rail's private debt. Exhibit 8 below shows that public spending on the railways in real terms has increased since privatisation in the mid-1990s and is consistently higher in the 2000s than in the decade before privatisation. The near threefold increase in sector subsidy in the first half of the 2000s as Network Rail scrambled to make up for the neglect and mismanagement of the privatised rail infrastructure by Railtrack, has been contained; but public subsidy has only fallen back to around £4 billion in 2012

<sup>38</sup> Quoted in Wolmar, C. (2012), *On the Wrong Line: How Ideology and Incompetence Wrecked Britain's Railways*. Kemsing Publishing, (Kindle edition, location 6594).

(exhibit 10). The sector subsidy jumps about year on year before and after privatisation but is typically higher than in most years before privatisation.

**Exhibit 10:** Total government spending on the railways<sup>39</sup> (£m, 2012 prices)



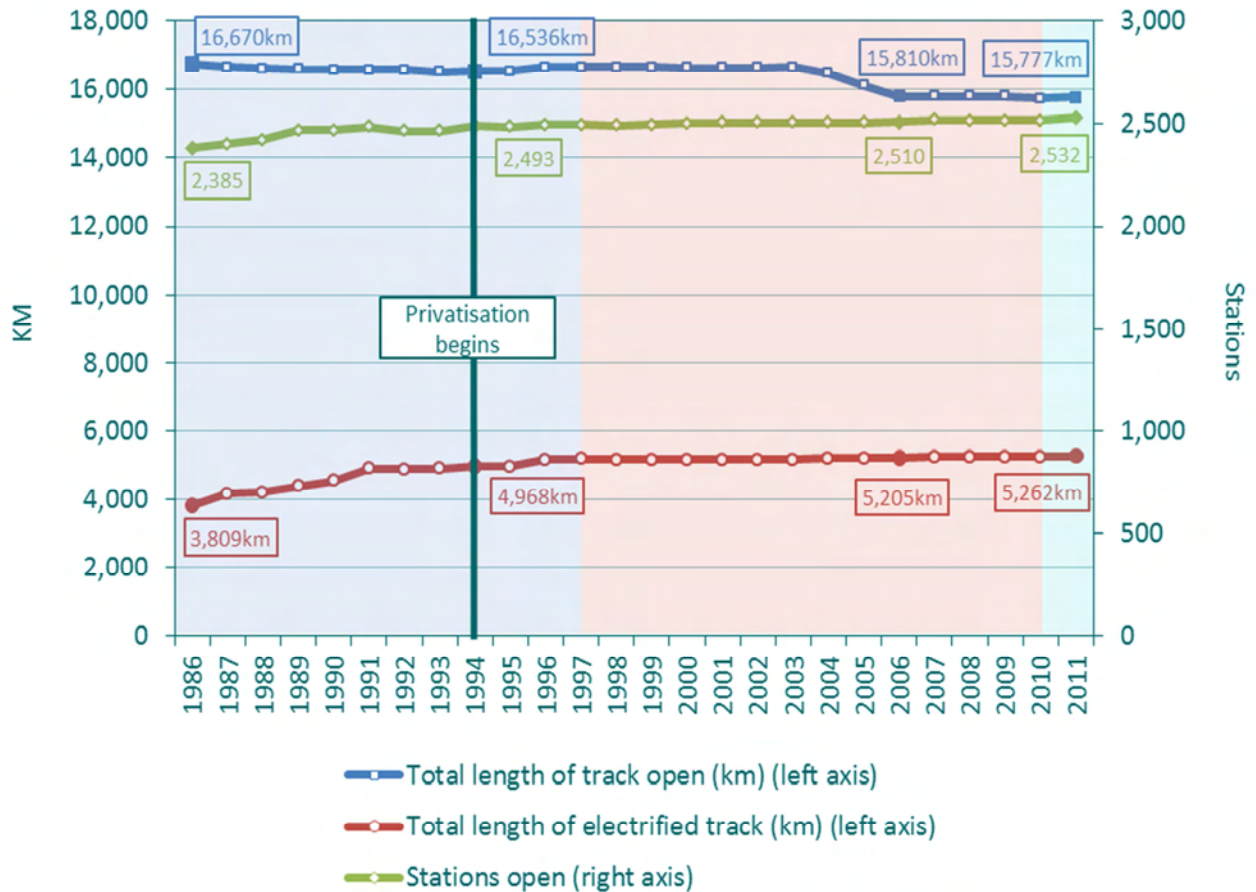
As for investment, it is of course very difficult to measure and compare total cash investment under two quite different systems, especially when the privatised system includes many different companies. But it is possible to proxy investment spend by counting the improvements and expansion which investment buys. The privatised companies inherited an investment starved system where BR track and rolling stock were often antique and passenger numbers have since increased; if large scale private investment was going into the rail system from the late 1990s, we would then expect to see some combination of increased total track length, more electrified track, a larger number of stations and a fall in the average age of the rolling stock.

On every single one of these proxy measures of investment, there is no evidence that privatisation has led to any significant improvements; and average age of rolling stock has actually increased. As exhibit 11 shows, if we date the start of privatisation proper from 1996 when Railtrack floated on the London Stock Exchange and the first TOC franchises started (the process had begun in 1994 when the Railways Bill came into effect), the length of track open has declined by almost 1,000km, the number of stations open has increased by only 35 over the 15 years from 1996-2011 as compared to a rise of 112 between 1986 and 1996 under the investment-starved BR system. Of course, some stations or lengths of track may have become redundant, so the total length of electrified track is arguably a more revealing measure of improvement, especially as British Rail had not electrified all the main lines out of London and had also failed to electrify Northern commuter services. On this decisive measure, the length of electrified track increased by only 99km between

<sup>39</sup> Source: ORR.

1996 and 2011. To be fair, some £10 billion was spent after privatisation on upgrading the West Coast Main Line but the bulk of this work was carried out by the publicly funded Network Rail, not the private sector, and did no more than replace an outdated pre-1974 electrification; and there was never any money left over to electrify the old Great Western line out of Paddington.

**Exhibit 11: Total track length, electrified track and stations open pre and post privatisation**<sup>40</sup>



The position on the average age of the trains, or ‘rolling stock’, is even more revealing. The rolling stock is what the customer sees and uses, and in addition to the boost to customer satisfaction, new rolling stock should be a boon to operators because it is safer, greener and more reliable. The privatised system did replace the old Southern Region slam door rolling stock, which was 35 years old; but has persisted with BR InterCity 125 stock, which is now coming up to 35 years old. The aggregate evidence is devastating. As exhibit 12 shows, private investment in rolling stock has been lower over the past 5 years than in the five years prior to the passing of the 1993 Railways Act. The average age of the UK’s rolling stock was 16 years at privatisation, and is today nearly 18 years.

<sup>40</sup> Source: ORR.

**Exhibit 12:** Investment in rolling stock: the last five years compared to the five years before privatisation<sup>41</sup> (£m, 2012 prices)

State rolling stock investment five years before privatisation		Private (but state guaranteed) rolling stock investment over the past five years	
£m		£m	
1989	439	2008	452
1990	451	2009	392
1991	598	2010	459
1992	794	2011	283
1993	927	2012	369
Total 1989-1993	3,209	Total 2008-2012	1,955

If we consider privatisation outcomes against promises on the key measures, privatisation has not brought in private investment and the state's financial burdens have increased. There are two issues arising. First, there is the economic question of how can this be? The next few chapters provide an answer by focusing on the pernicious effects of the tripartite organisation of rail, which sustained the franchise system, the ROSCOs and all the rest. Second, there is the political conundrum about the paradoxical effects of failure. Disappointment with outcomes has not discredited the privatisation project but increased determination to deliver the promised benefits. After twenty years, privatisation is no longer an emotional attachment or a hope, but an *idée fixe* for the political classes who are the co-dependents of newly entrenched private contractors.

## Chapter 2 – The habitat of value extraction (a) the TOCs and heads they win, tails we lose

### Charge 1 Privatisation created a habitat for value extraction at the public expense where the TOCs play heads they win/tails we lose

The sector wide result of rail privatisation is a habitat within which risk and/or investment averse private companies position themselves as *value extractors* who claim cash which comes indirectly from high public subsidies (with government taking the operating risk and supplying investment funds).

A train franchise is not a license to print money because the TOCs have variable results in terms of profitability. But franchise bidders are attracted by a (low investment cost) option on upside profits with most of the downside risk passed to the state under a game whose rules for the taxpayer are 'heads they win and tails we lose'.

<sup>41</sup> Source: ORR.

As we have seen, privatisation was promoted through arguments and assumptions about the generic character of private enterprise which, in the political imaginary is always risk taking, innovative and flexible. What this did not consider was that the character of corporate enterprise varies according to their habitat so that defence contracting (with the state) is a world of cosy cost-plus contracts; chain retail is about rolling out formulaic success; banking is about privatising gains before socialising losses; and so forth, sector by sector. When habitats change and business models are undermined, large private corporates can be quite as inflexible as public sector organisations limited by culture and competence. From this point of view, the first question in any privatisation should have been about the kind of habitat that was being created and what kind of behaviours and competences this habitat would encourage.

The tragic design flaw in rail privatisation was that the Conservative government and the DfT did not see that the habitat being created for the infrastructure company, train operating companies and rolling stock leasing companies would encourage specific behaviours that were the exact opposite of those envisaged in the generic stereotype. This was a habitat that encouraged risk and investment averse behaviours by private companies which would insist on contract, do little they were not paid to do and take a narrow management accounting view of their sectional interest.

In slightly different form (without the contractualism) such behaviours had of course induced management led failure in British tradable goods sectors like textiles and autos after World War Two. Privatisation now offered British management the consolation of a huge reservation for business which was sheltered from international competition but nevertheless was sometimes challenging. The usual challenge was not the aggression of a newly installed regulator defending the public interest but the way that sectoral specifics complicated cost recovery. Thus, in an industry like water it was possible to simply bill the customer for operating expense and capital investment, but everything was much more complicated in loss-making rail with inadequate cost recovery from existing fares and political constraints on higher fares.

In the rail sector, privatisation opened up a struggle for position as whole groups of companies like the TOCs and ROSCOs positioned themselves as value extractors. A loss-making sector could of course generate profitable operating positions for individual companies (or a class of company). The successful could claim cash that would of course come indirectly from high public subsidies within a system with inadequate cost recovery where profit at one point inevitably meant losses at another. Incidentally the contract system also opened up new possibilities for adroit companies to pass operating risk back to the government which would inevitably end up supplying or guaranteeing large scale investment (because there was no realistic prospect of private return for any investing company unless many other companies within the sector lost money).

In this and the next chapter, we tell the story of how the TOCs and ROSCOs adapted to this habitat which rewarded positioning and value extraction. The outcome was rather different for each class of company. The TOCs had a kind of no cost option on profit through playing in a casino where winning was not guaranteed but they had a cap on downside operating losses. The ROSCOs bought tickets in a rather unusual kind of lottery because every ticket was a winner. But, let us begin with some essential background.

## Background

Privatisation split the integrated British Rail system into three parts. An infrastructure company (Railtrack 1994-2002 and now Network Rail) owns the track, rolling stock operating companies (ROSCOs) own the trains, and train operating companies (TOCs) run the trains as the public-facing actors in the system. There are currently 17 rail franchises in the UK which include long-distance inter-city routes and urbanised commuter operations – 25 were created at privatisation in 1996 by geographically subdividing the network so that the various long distance main lines, the high volume London and South East operation, and low volume provincial services all went to different operating companies.

**Exhibit 13: Changes in UK rail franchising**<sup>42</sup>

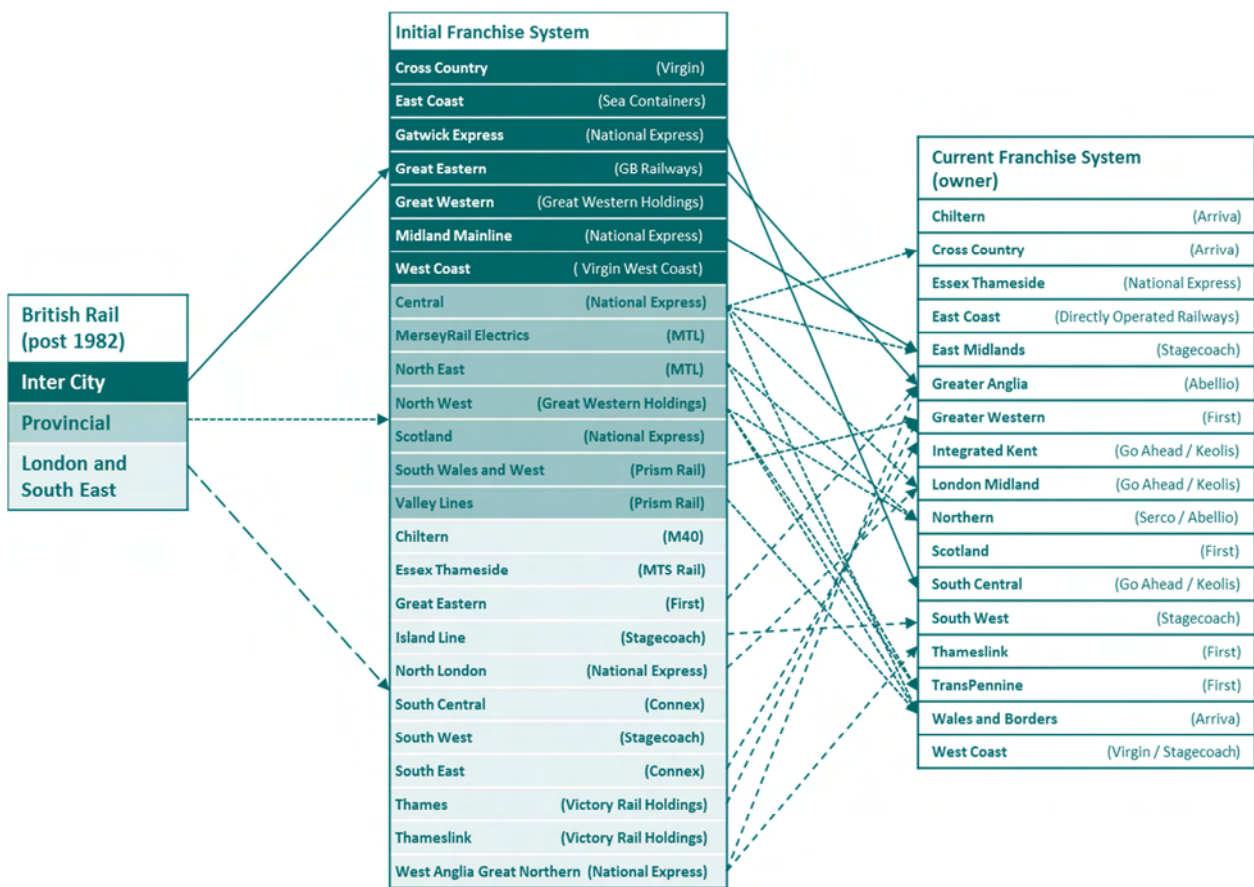


Exhibit 13 explains the original division at privatisation and the subsequent frantic restructuring. Reform programmes from 2000 onwards merged, split up and disbanded various franchises in an attempt to rationalise the network by reducing overlaps between different operators – putting humpty dumpty back together again is, as ever, more challenging than breaking him. The trend towards consolidation is continuing though, with the merger of the Northern and TransPennine franchises into a single franchise for the north of England, the most likely major forthcoming reform of this variety. Ironically of course, this consolidation has gone against the provision of passenger choice and diversity which was a promise of privatisation.

<sup>42</sup> Source: Derived from ORR data.

Alongside the government's continual reworking of the franchise map, the franchises have changed hands between different owners to a much greater extent than exhibit 13 conveys: some franchises have changed hands as the owners found themselves out-bid when the franchise is re-tendered, other TOCs have quit midway through a franchise period, others have been bought out midway through. The general trend however is apparent from this snapshot contrast between the onset of privatisation and the present day: there has been a steady consolidation of the system in the hands of a shrinking number of multinational transport and utility companies.

These companies for the most part fall into three categories.

- (1) First, there are the local monopoly PLC bus companies which were born out of the privatisation and deregulation of Britain's municipal bus system in the 1980s; they saw train operating could be a profitable adjunct and hence First Group, National Express, Stagecoach and Go Ahead all set up rail divisions.
- (2) Second, there are the subsidiaries of foreign state-owned rail companies who recognise (much as with gas and electricity) that the British government is generously offering them a profit opportunity; Arriva is a wholly-owned subsidiary of the German national rail company Deutsche Bahn, Keolis is majority owned by the French national rail operator SNCF, and Abellio is owned by the Dutch state operator Nederlandse Spoorwegen.
- (3) In the third category are Virgin and Serco, two companies willing to try their hand at more or less anything which comes their way, which in Serco's case is mainly business from the state's downsizing. The smaller companies listed at the beginning of privatisation in the middle column of exhibit 13 were predominantly management buyout teams whose strategy was typically not to operate but to exit by selling out quickly and at a substantial profit to a larger player.

The number of operators may decline but, when the DfT issues invitations to tender for the various franchises, there are still enough companies queuing up to bid to give the impression of healthy competition. How the franchising system has worked in the ideal world is as follows (bearing in mind details of the system have been tweaked at various intervals). The DfT issues a detailed invitation to tender specifying what the successful bidder must do, including how many trains it runs, where to, and at what standard of service. The aspiring TOCs produce a bid outlining how they would run the service, what improvements to the service they would offer, what investment they would make (e.g. in stations or rolling stock), how much they want to receive in subsidy and, most importantly, how much they would pay the government as rent in *franchise premiums* for the privilege. The premium payments TOCs promise when bidding for the franchise are fixed (though subject to renegotiation within limits) and they must keep paying them, but whatever the TOCs have left at the end, they can take home as their own profit (unless revenue is substantially higher than expected, in which case the TOC may have to pay higher premiums). The franchise competition winner is the company the DfT considers to have made the most attractive offer within the realms of what is deemed practically achievable.

In the absence of on-going rail service competition within each franchise region, the periodic bidding competition for franchises on the railways has to do the work of driving better services, higher revenues and lower costs which (with increased premiums payments to the government) should notionally reduce the requirement for subsidy. But, as we have already noted, the

requirement for subsidy has not decreased and instead things are going wrong in a very interesting way because, as we shall see, successful franchise bidders are winning by over-bidding and making unrealistic revenue projections (with back-loaded premium payments as described in the introduction to this report).

Value extraction on different parts of the network intersects with different possibilities of cost recovery from fares. These possibilities are determined by persistent economic and technical characteristics which were already clear under British Rail's three-way division of services. Under British Rail, Network South East served commuters around the London area travelling short distances in high frequency and density during the morning and evening rush hours – *if* fares could be ramped this could make money, given that capacity utilisation was guaranteed. The InterCity lines were more expensive to run, but traditionally in the UK and elsewhere in Europe today have been the most profitable (or least subsidised) routes given the higher value of travel, all day demand and the customer preference for advance booking which eases planning for capacity utilisation. Of these two services then, one has low value but high density, and the other high value and low density.

Regional, or as they were previously called, 'provincial' services faced much greater problems than the InterCity and South East services in terms of cost recovery from fares, since they were catering for short distance, low-fare journeys but in low population density areas. These were maintained for social rather than commercial purposes, or rather, their commercial benefits were diffusely distributed to the extent that cost recovery from the services themselves was always inadequate and substantial subsidy was always required to keep them running. Given the uncertainty of cost recovery throughout the system and the inevitability of operating losses on 'provincial' lines, the good news for the TOCs was that requirement for government subsidy was no bar to their taking private profit.

Train operators receive two forms of direct subsidy: *franchise subsidy payments* (pre-arranged as part of the subsidy-premium deal from winning the franchise) which are in effect grants to ensure the operator earns commercial returns, and *revenue support* which, after four years of the franchise have elapsed (under the cap and collar system), is paid by the government to the TOCs when revenue dips below a certain level and by the TOCs to government when it rises above a certain level (more detail in chapter 5). In calculating net direct subsidy, we should subtract any franchise premium payments made by the TOCs. As exhibit 14 shows, during 2011/12, out of 17 active franchises, eight TOCs were recipients of net overall subsidy (shown as a positive number under total subsidy) and eight out of the 10 eligible to receive it were net recipients of revenue support, meaning they had undershot their revenue projections outlined in their successful franchise bid. To put it another way, almost 50% of franchise bids active at the time of this study have proven to be excessively optimistic (an issue discussed in greater depth in chapter 5). This figure may well rise in the coming years since not all of the franchises in 2011/12 were yet eligible for revenue support, which is only available after four years have elapsed.

**Exhibit 14: Government net direct subsidy for current UK rail franchises 2011/12<sup>43</sup>**

	Passenger miles	Net subsidy <sup>44</sup>	Net subsidy per passenger mile
	Miles millions	£m	Pence per mile
<b>Arriva Trains Wales</b>	<b>710</b>	<b>137.0</b>	<b>0.19</b>
C2C	615	-12.1	-0.02
<b>Chiltern Railways</b>	<b>622</b>	<b>6.5</b>	<b>0.01</b>
<b>CrossCountry</b>	<b>2,021</b>	<b>6.7</b>	<b>0.00</b>
East Coast <sup>45</sup>	3,040	-187.7	-0.06
East Midlands Trains	1,364	-40.4	-0.03
First Capital Connect	2,147	-162.7	-0.08
First Great Western	3,629	-110.1	-0.03
<b>First Scotrail</b>	<b>1,667</b>	<b>305.0</b>	<b>0.18</b>
<b>First TransPennine Express</b>	<b>979</b>	<b>78.1</b>	<b>0.08</b>
Greater Anglia	407	-16.9	-0.04
<b>London Midland</b>	<b>1,299</b>	<b>65.3</b>	<b>0.05</b>
National Express East Anglia <sup>46</sup>	2,101	-72.6	-0.03
<b>Northern Rail</b>	<b>1,325</b>	<b>96.7</b>	<b>0.07</b>
<b>Southeastern</b>	<b>2,566</b>	<b>86.7</b>	<b>0.03</b>
Southern	2,730	-16.7	-0.01
South West Trains	3,554	-228.6	-0.06
Virgin Trains	3,680	-165.7	-0.05

The table offers only a snapshot from one year, and it is important to stress that the TOCs in receipt of subsidy and the levels of subsidy are subject to large changes year on year. Note also that the table includes only explicit net direct subsidies (in the form of franchise subsidy payments minus franchise premium payments plus revenue support); it does not include the hidden and indirect subsidy which TOCs receive via low track access charges funded and underwritten by government grants to the infrastructure company, Network Rail (discussed in chapter 4).

The dependence of many franchisees on direct subsidy has highlighted another peculiarity of the system: the franchise system has no rules that prevent TOCs which are only profitable thanks to high (direct) subsidy from distributing those profits to shareholders, even though, when subsidies

<sup>43</sup> Source: DfT /ORR. Notes:

<sup>44</sup> Direct subsidies to TOCs less premium payments and clawback payments. Calculation excludes indirect subsidies from Network Rail e.g. full economic cost track access charges.

Note: The 'Passenger miles' column refers to annual total miles, the 'Net subsidy' column refers to direct subsidies received less premium payments and any other penalties and the final column is a calculation from the two previous columns. A positive monetary total means the TOC was a net subsidy recipient and a negative total means the TOC made payments to the government.

<sup>45</sup> Operated by Directly Operated Railways, a company wholly state owned.

<sup>46</sup> National Express East Anglia appears here despite no longer existing as a franchise because it was still active in the year to which this data relates

are high it is effectively taxpayers' money which is being distributed. Exhibit 15 compares the net profits and dividends over the past five years for the five companies which received the highest total subsidy in 2011/12: First Scotrail, First TransPennine, Northern Rail, Southeastern and Arriva Trains Wales. There are no constraints on payment of dividends by such subsidised companies, so that between 2007 and 2011 the five most subsidised franchises distributed between 81% and 106% of total profits to their parent company.

**Exhibit 15:** Net profits and dividend distribution rates for the top five recipients of public subsidy in 2011/12<sup>47</sup>

	Arriva Trains Wales		First Scotrail		First Transpennine		Northern Rail		Southeastern	
	Net profit	Dividends as a share of net profit	Net profit	Dividends as a share of net profit	Net profit	Dividends as a share of net profit	Net profit	Dividends as a share of net profit	Net profit	Dividends as a share of net profit
	£m	%	£m	%	£m	%	£m	%	£m	%
2007	8.3	168.2	18.6	91.4	22.6	90.9	13.9	143.8	17.8	78.7
2008	10.5	85.4	18.4	97.6	27.6	57.9	19.6	99.0	24.0	74.9
2009	10.2	98.1	15.6	115.1	31.2	136.2	21.2	131.1	16.0	74.8
2010	12.6	87.2	14.4	97.2	35.9	83.5	28.3	78.7	6.2	192.6
2011	17.7	84.8	17.3	92.7	50.1	61.8	27.6	100.1	18.3	60.0
Total	59.4	99.4	84.3	98.4	167.4	83.6	110.5	105.9	82.4	81.3

### Rules of the game: TOC win, lose or draw

The general principle of rail franchising is that the TOC is a Special Purpose Vehicle (SPV) which is a subsidiary of a multinational parent and distributes all declared profits to its corporate parent. The DfT and ORR do not provide systematic, accessible and long-run historical data which would enable an inquisitive citizen to gauge the overall extent of dividend extraction by the TOCs. A trade union sponsored study published in 2012, *Rebuilding Rail*, estimated the cumulative leakage of funds from the rail system as a result of TOC dividends was £507-1000m.<sup>48</sup>

As we have argued in the introduction, it would be wrong to make too much of the scale of this leakage because the dividends are, in effect, the fee for service charged by the TOCs and, in the most recent year of 2011, dividends accounted for no more than 2% of turnover. But the implication is clear: If the vague promise was that private companies would contribute investment to the railways, TOCs were set up on the opposite principle that they would always be extractive.

<sup>47</sup> Annual report and accounts and FAME, BvD.

<sup>48</sup> *Rebuilding Rail*, 2012, p.18. The cumulative dividends cover a period of 1997-2009 (for the lower end of the estimate) and 1997-2010 (for the upper end) and incorporate different assumptions about the proportion of parent company dividends attributable to UK rail. See note 15 in *Rebuilding Rail*.

In our view, the fundamental issue is not the size of the fee extracted for the service but the terms of extraction where the balance of reward and risk favours the company and disadvantages the contracting state which appears to be quite incapable of writing a contract which protects the taxpayer. The contract for a rail franchise gives the TOC, in effect, an upside option on profits which can all be distributed; apart from the costs of bid preparation, the up-front cost is negligible because the franchisee makes no significant initial investment.

Profit is not guaranteed because as exhibit 7 in the introduction showed, many franchises either just about break even or lose money; the prospect of losing money in the later stages of the franchise is increasingly important in a system which encourages overbidding with a back-loaded premium profile. But the downside risk of operating losses is limited because the franchise includes a break clause which allows the franchisee to pay only a modest financial penalty for abandoning the franchise. The rules are such that TOC s have been gaming the system to take early reward and avoid later risk. The recent formula for success is to win the franchise by overbidding with back-loaded premium payments so that the TOC can declare and distribute profits earlier in the franchise and then decide whether to walk away and avoid ruinous premium payments later in the franchise.

The rules of the franchise game, the extent of franchisee over-bidding and the revenue/subsidy characteristics of the franchise all intersect to create three different outcomes in terms of value extraction where the TOC can win, draw or walk away. But, as we will argue below, in no case has a franchisee ever made and lost a significant investment stake. In all cases the result depends on direct and indirect state subsidy and the absence of public interest rules on matters such as bid profile. So the taxpayer always to some extent loses.

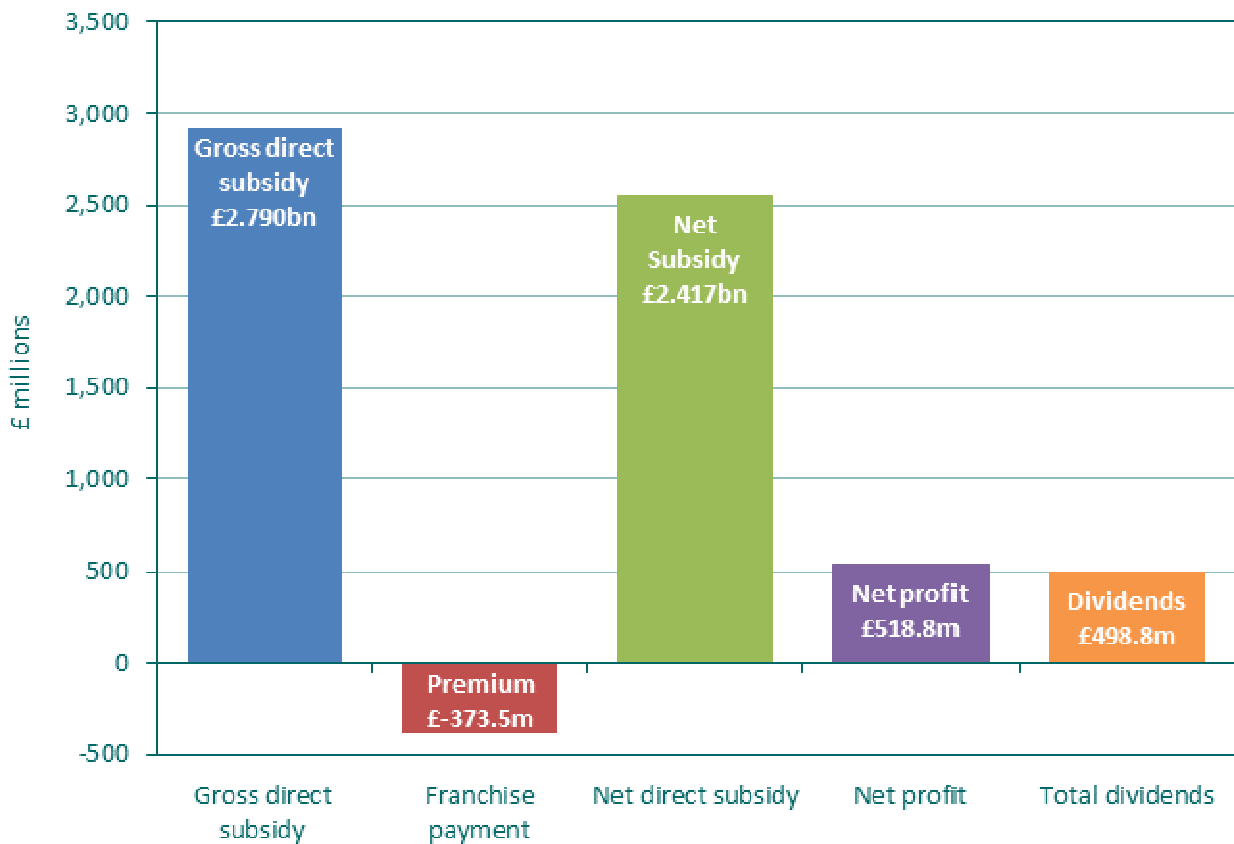
1. The TOC wins: in a variety of franchises (main line or low density) thanks to direct subsidy and without significant investment the TOC declares and distributes a profit to the parent company.
2. The TOC draws: in some franchises state subsidy does no more than enable the TOC to break even so that the parent company makes no investment, takes no profit but stays in the rail business to bid for other franchises.
3. The TOC walks away: operating losses emerge either because revenue falls below expectations in a downturn or because back-loaded premium payments are due; then, with no capital in the business and no claw-back of previously distributed profits, the franchisee takes a small hit and walks away, and is not barred from bidding again at future tenders.

The cases below illustrate the diversity of outcomes in various circumstances and in each case we emphasise the absence of any significant investment, the cumulative dependence on (and recycling of) direct state subsidy and the franchisees' limited active role in driving performance improvements or managing deterioration over the life of the franchise. All the analysis distinguishes between gross and net direct subsidy (with and without offsetting premium payments) and excludes consideration of indirect subsidy in the form of low track access charges under Network Rail (the track access subsidy was, in effect, paid directly to TOCs under the Railtrack regime).

## 1. The TOC wins: Virgin West Coast<sup>49</sup> and Arriva Trains Wales

Let us begin by considering Virgin which in 1997 took over the prime main line West Coast franchise via West Coast Trains<sup>50</sup>. Sir Richard Branson in our opening quotation tells a story of operating effort, but the accounts of his West Coast Trains SPV (in which Virgin has a 51% stake and Stagecoach a 49% stake) tell a different story of financial engineering. There was an original modest investment but this was in the form of debt not equity risk capital. Virgin as parent put up £21m (nominal) in group loans<sup>51</sup> at the start of the franchise, which meant that in the event of bankruptcy Virgin was near the head of the queue to pull its money out.

**Exhibit 16:** An analysis of direct state subsidy and extraction: Virgin West Coast Trains cumulative direct subsidies<sup>52</sup>, net profit and dividends 1997-2012<sup>53</sup> (2012 prices)



This modest investment unlocked a huge cumulative state subsidy without obligation initially to make large franchise payments. This TOC’s net state subvention is cumulatively £2.79bn over the

<sup>49</sup> West Coast Trains Limited, a UK registered company operates the West Coast franchise. It is a wholly owned subsidiary of Virgin Rail Group.

<sup>50</sup> Virgin Rail Group through its subsidiary West Coast Trains began operations in March 1997. In October 1998, Stagecoach Rail Holdings acquired just below 49% of Virgin Rail Group shares. The 2012 annual report and accounts lists Virgin Group Holdings Limited, a British Virgin Islands registered company as the ultimate parent company.

<sup>51</sup> West Coast Trains Limited annual report and accounts, 1997.

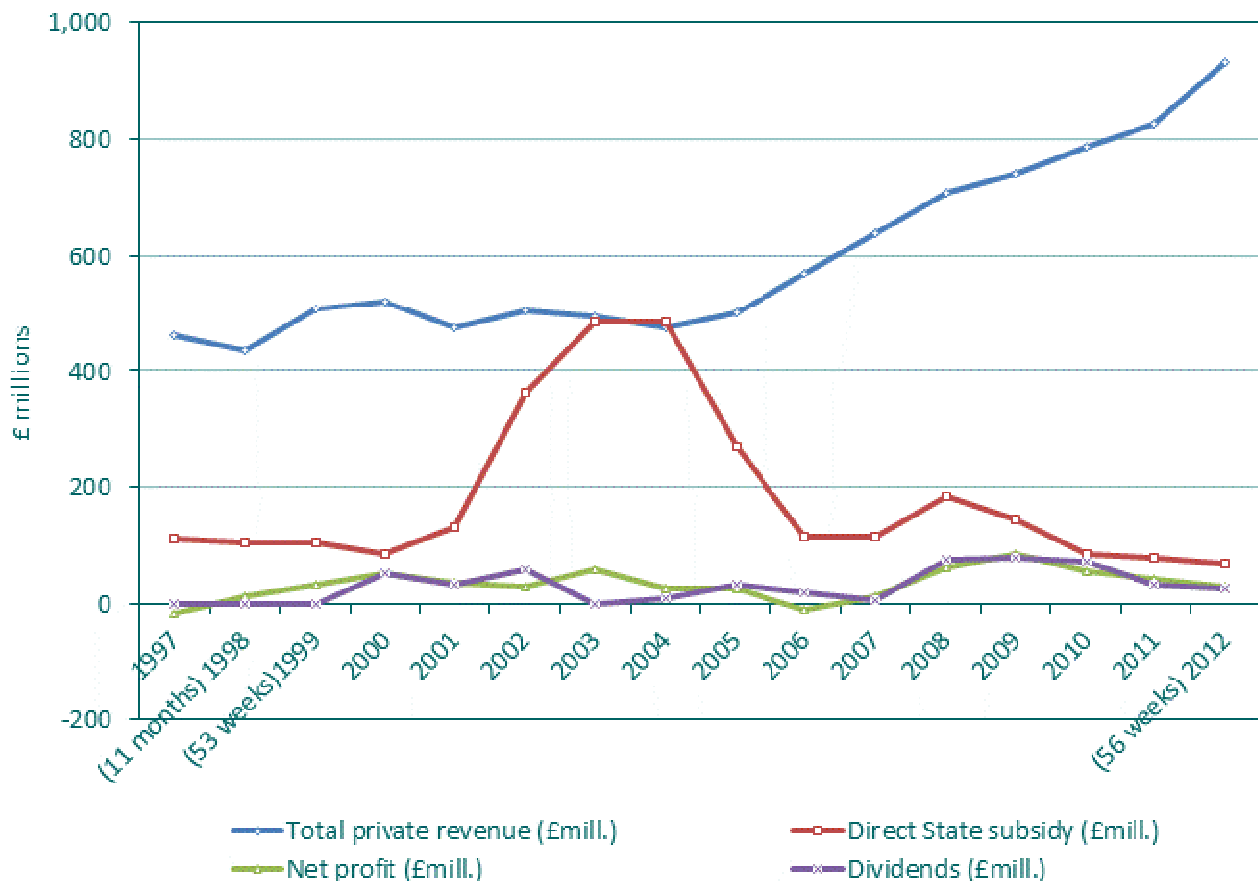
<sup>52</sup> Gross Subsidies include revenue grants, performance payments and other compensation like franchise subsidies. Net subtracts any offsetting franchise premium payments by the company to the State. The exhibit excludes subsidies related to track access under Network Rail. Under Railtrack’s tenure, these subsidies for track access charges were paid directly to the TOCs. .

<sup>53</sup> Source: West Coast Trains Limited, annual report and accounts, various years.

course of the franchise from 1997 to 2012. With this support (and protection from competitors on franchise routes via Moderation of Competition clauses) it was relatively easy to find £519m of net profit and extract almost all of that in £499m of dividends.

Exhibit 17 shows the year-by-year relationship between state subsidy, private revenues, profits and dividends. There is apparent improvement in performance since 2003-4, with revenue rising sharply and direct subsidy falling, but we can enter several qualifications. First, Virgin West Coast is hardly an example of a robust and independent profit maker because in nearly every year of the Virgin franchise direct net state subsidy exceeds profit (which would vanish without subsidy). Second, we would dispute Virgin's claims that increased private revenue on the track is a result of the company's efforts. As we note below, new track, trains and stations have almost all been provided from elsewhere, while rising use of rail can be attributed, as argued in chapter 6, to the increasing expense of car use and sustained growth of GDP from the early 1990s to 2008.

**Exhibit 17:** Virgin West Coast Trains revenue, direct gross subsidy<sup>54</sup>, profit and dividends 1997-2012<sup>55</sup> (2012 prices)



In the Virgin press release which opens this report, Richard Branson boasts of a West Coast Main line transformation 'under our stewardship' and represents Virgin as a purposive, enterprising prime mover which sets and achieves difficult targets. It would be more accurate to represent Virgin as a windfall beneficiary which claims the credit for what others have done at huge expense

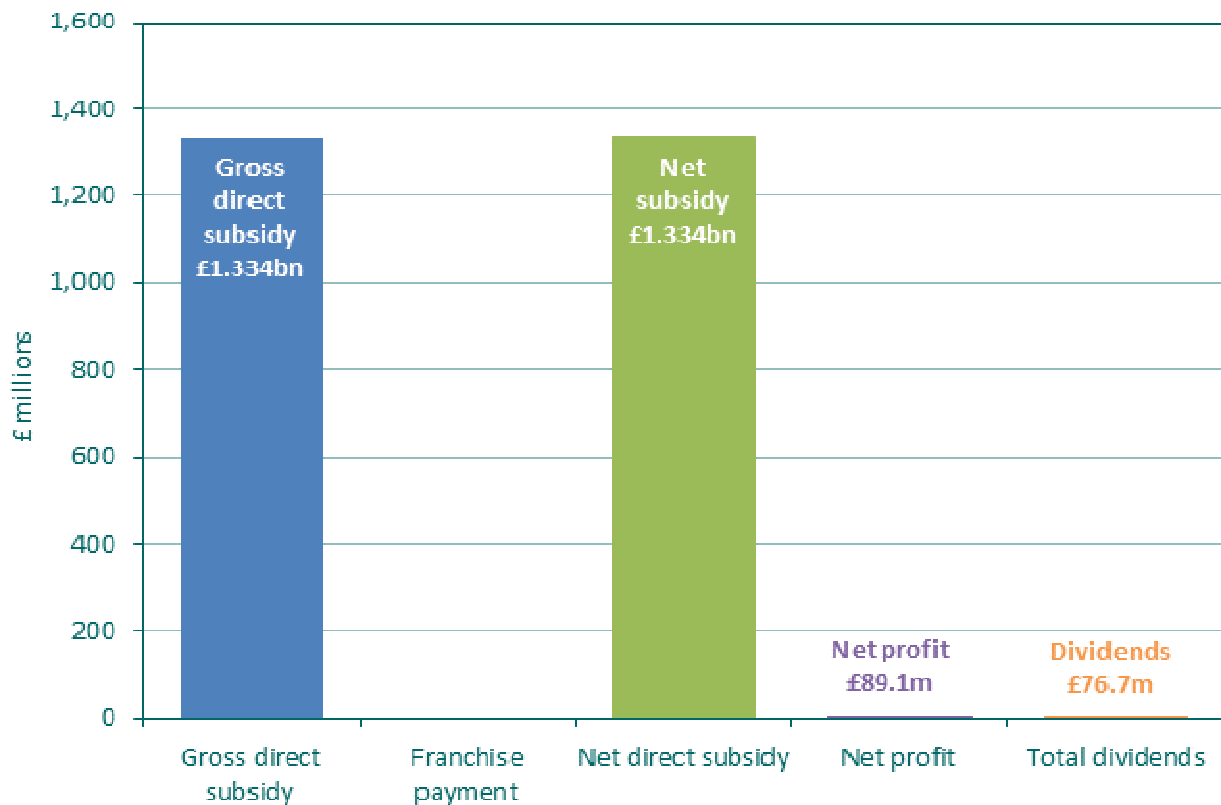
<sup>54</sup> Note: The graph refers to gross direct subsidy and therefore excludes franchise payments. In 2011 and 2012 West Coast Trains made franchise payments of £370mill (nominal prices).

<sup>55</sup> West Coast Trains, annual report and accounts.

to transform its revenue line. The new high-speed tilting Pendolino trains which run along the West Coast mainline from 2002 are not bought or owned directly by Virgin Rail Group but leased from the Angel Trains ROSCO. The new trains required huge expenditure on track upgrade, which was paid for by Network Rail, as were the bulk of improvements to major stations such as Manchester Piccadilly. The WCML upgrade ended up costing £9bn, paid for primarily via Network Rail and thus effectively the taxpayer, running considerably over time to finish in 2008 and over the original £2.5bn budget estimate from Railtrack. With engineering works causing disruption on the line, in 2002 Virgin were moved onto a lucrative management contract with a fee provided for running the service with no risk. This only came to an end in 2006. And now, with the franchising process in disarray, Virgin has been granted an extension of their franchise to last until 2017.

In other cases the value extraction and its relationship with state subsidy is even more remarkable. Consider, for example, Arriva Trains Wales which in 2003 took up the franchise to serve a low income and low population density area around Wales and adjacent areas in England. First Greater Western had the Cardiff to London main line service and Arriva took up a new franchise formed by the merger of the previous Valley Lines franchise with parts of the Central and Wales and West franchises.

**Exhibit 18:** An analysis of direct state subsidy<sup>56</sup> and extraction: Arriva Trains Wales cumulative direct subsidies, net profit and dividends 2003-2011<sup>57</sup> (2012 prices)



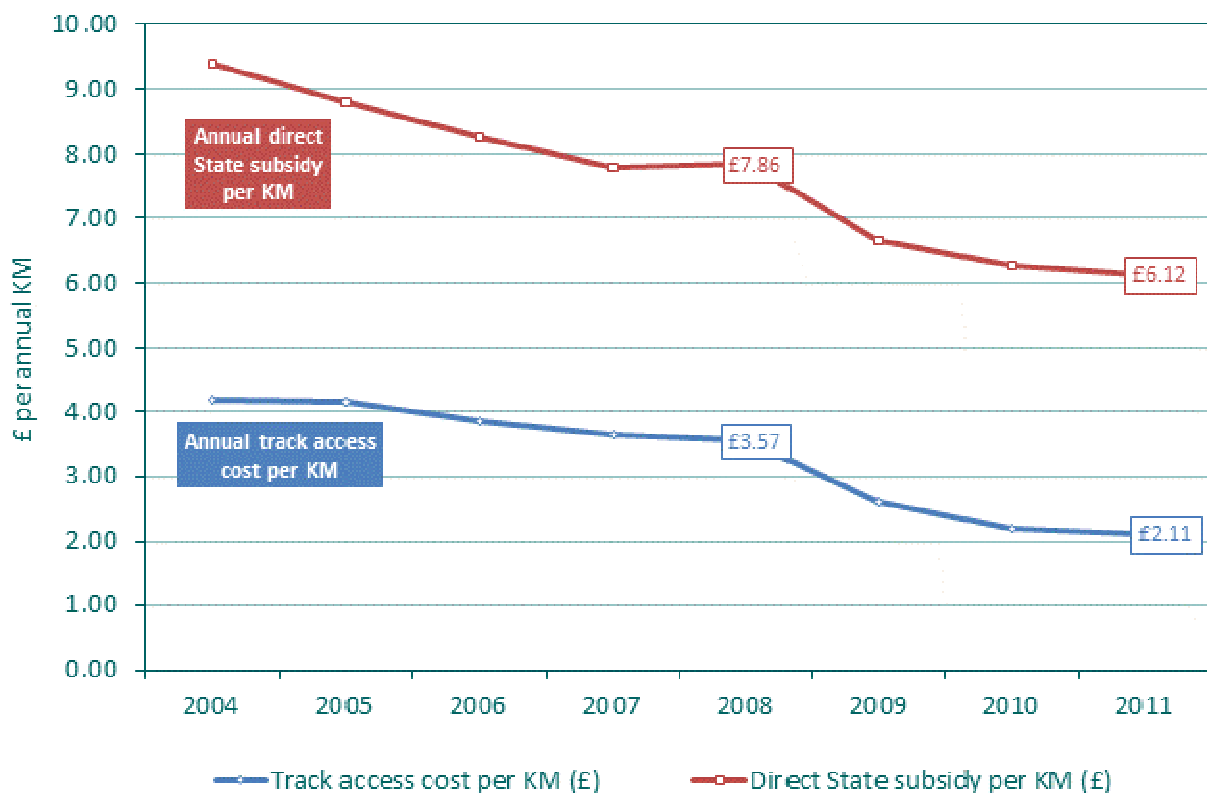
According to the Arriva web site, Arriva’s success is ‘delivered through better service, innovation and marketing’ and a ‘culture of integrity and honesty’. As we shall see, it would be more honest for

<sup>56</sup> Note: The graph refers to gross direct subsidy and net subsidy is after deduction for any franchise payments.

<sup>57</sup> Arriva Trains Wales annual report and accounts, various years.

the company to acknowledge its success is the result of financial engineering and generous direct subsidy, as we explain below. In other cases the value extraction and its relationship with state subsidy is even more remarkable. Consider, for example, Arriva Trains Wales which in 2003 took up the franchise to serve a low income and low population density area around Wales and adjacent areas in England. First Greater Western had the Cardiff to London main line service and Arriva took up a new franchise formed by the merger of the previous Valley Lines franchise with parts of the Central and Wales and West franchises. According to the Arriva web site, Arriva's success is 'delivered through better service, innovation and marketing' and a 'culture of integrity and honesty'. As we shall see, it would be more honest for the company to acknowledge its success is the result of financial engineering and generous direct subsidy, as we explain below.

**Exhibit 19:** Arriva Trains Wales revenue, direct gross subsidy<sup>58</sup>, profit and dividends 2003-2011<sup>59</sup> (2012 prices)



As always with TOCs, the first objective of the financial engineering is to ensure that the parent company has no large amount of risk capital in the business. As the up-front investment requirement was modest, this was done quickly by dividend extraction. The parent company, Arriva<sup>60</sup>, put in £5m of equity capital at the start of the franchise which was then recovered by the extraction of £4.9m in dividends at the end of their first year. Henceforth, Arriva (and thus Deutsche Bahn) was getting what amounts to a free ride which was very profitable because the franchise has generated dividends of over £75m for Arriva and Deutsche Bahn since the start of the franchise in 2003.

<sup>58</sup> Note: The graph refers to gross direct subsidy and therefore excludes franchise payments.

<sup>59</sup> Arriva Trains Wales, annual report and accounts, various years.

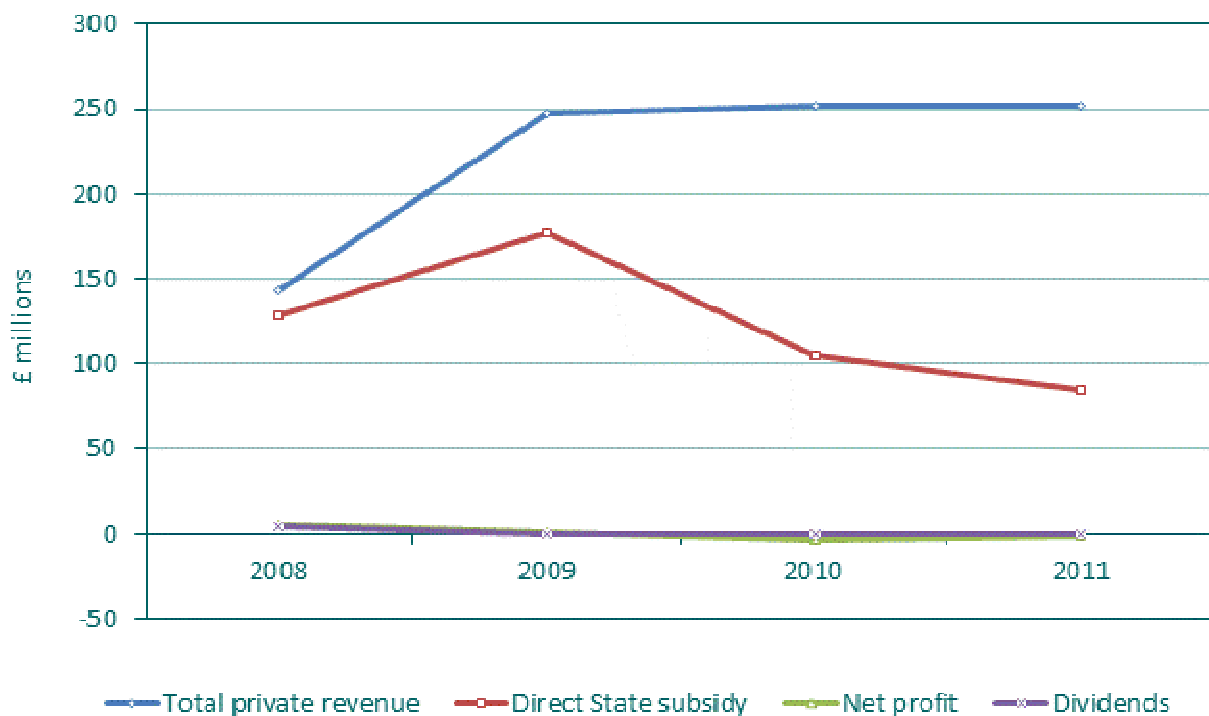
<sup>60</sup> Deutsche Bahn AG acquired Arriva in 2010.

Behind this success is a state subsidy which is so large that the extraction of £75 million is a mere detail. Exhibit 18 summarises the cumulative position and shows there were no franchise payments (because this franchise is negotiated directly by the Welsh Assembly, rather than the DfT/ ORR) so that the cumulative direct state subsidy is more than £1.2 billion. The year-by-year break down in Exhibit 19 is even more striking. In Arriva Trains Wales, the state directly contributes 60p in every £1 of revenue so that state subsidy has exceeded private revenue from fares in every year of the franchise. While Virgin West Coast Trains would not make a profit from the WCML without state largesse, Arriva Trains Wales would not run at all. In these circumstances we find it hard to understand why the taxpayer should tolerate the £75 million extracted by Deutsche Bahn when Welsh trains could be directly operated by the public sector or as a not for profit business organisation.

## 2. The TOC Draw: London Midland

While the WCML and some regional lines are money spinners, some franchises just about break even and that of course is an acceptable outcome when the franchisee does not invest much capital and retains the option to walk away in the later stages of the franchise. A good example of this outcome is London Midland formed in 2008 by combining the former operations of Silverlink, Central Trains and half of Maintrain, the maintenance company formerly run by National Express.

**Exhibit 20:** London Midland revenue, direct subsidy<sup>61</sup>, profit and dividends 1997-2012<sup>62</sup> (2012 prices)



<sup>61</sup> Subsidies include revenue grants, performance payments and other compensation. After the formation of Network Rail, subsidies related to track access were paid directly to the company. Under Railtrack's tenure, state subsidy for track access charges were paid via the TOCs. Franchise payments relate to the premium paid by the franchisee to the state. Note: The graph refers to gross direct subsidy and therefore excludes franchise payments.

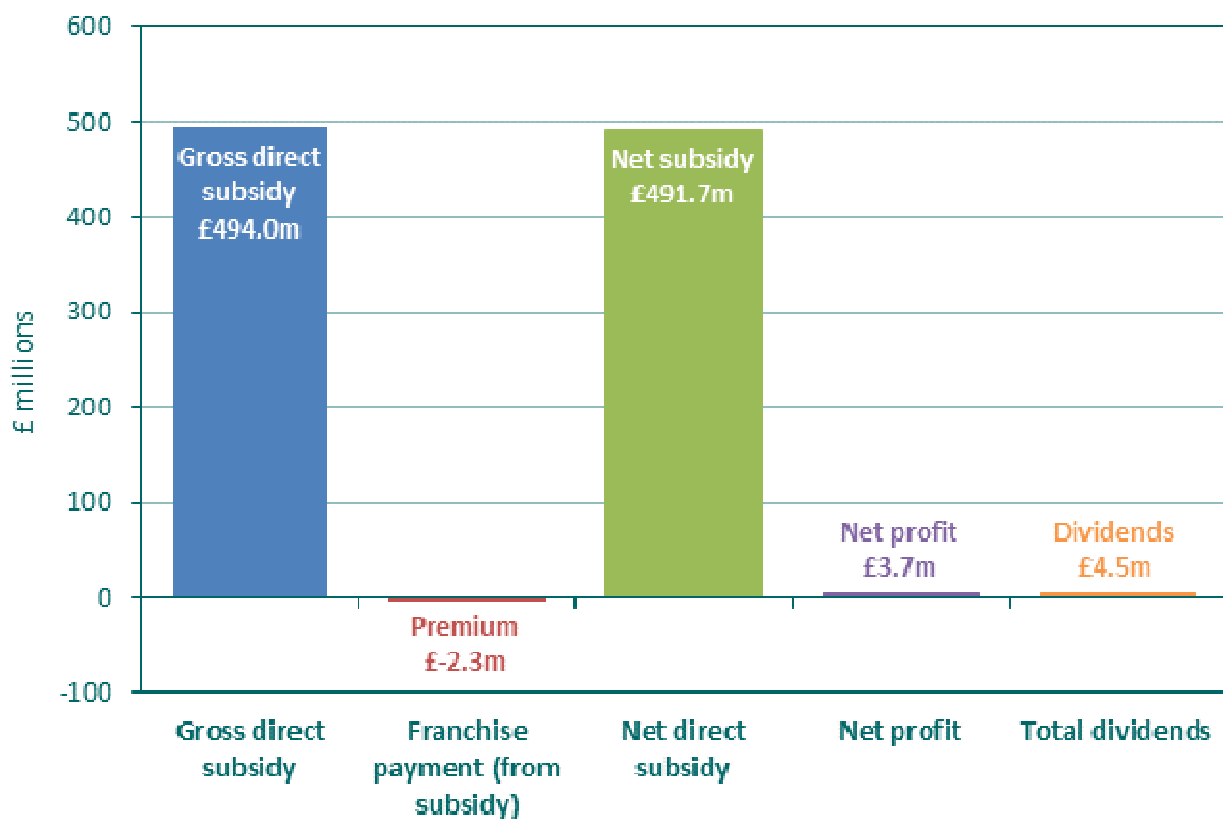
<sup>62</sup> London Midland is the trading name of London & Birmingham Railways.

The parent company Govia, a joint project between the Go Ahead Group and Keolis (majority owned by the French state railway provider, SNCF) put in £14.5m in equity capital under the conditions set under the agreement, but in the first year pulled out £4m as dividends.

This was a good start in limiting downside risk because little capital was now tied up in the business but, as exhibit 20 shows, operations did not then go well. The year-on-year figures are most revealing about what went wrong as the company bumps around breakeven. After making a modest profit in 2008, London Midland was caught by the recession which affected passenger volumes almost everywhere, but particularly in the commuter belt areas serving London. Revenue stalled because of this even though the Birmingham-Liverpool route increased its traffic.

The cumulative totals add more insight into the TOCs' world of politically constructed profits (which have little to do with the mundane business of running trains). London Midland can reduce expenditure marginally through cost-cutting measures such as its attempts to close down ticket offices and casualise its train drivers.<sup>63</sup> But, the fundamental problems of London Midland are on the revenue side with direct state subsidy declining and passenger revenue flat.

**Exhibit 21:** An analysis of direct state subsidy<sup>64</sup> and extraction: London Midland cumulative direct subsidies, net profit and dividends 2008-2011<sup>65</sup> (2012 prices)



<sup>63</sup> BBC News 'London Midland cancels more trains due to driver shortage' 09/11/2012. Available at <http://www.bbc.co.uk/news/uk-england-20268958>, BBC News 'London Midland ticket office closure plans overruled' 17/09/2012. Available at <http://www.bbc.co.uk/news/uk-england-19627116>

<sup>64</sup> Note: The graph refers to gross direct subsidy and therefore excludes franchise payments.

<sup>65</sup> Arriva Trains Wales annual report and accounts, various years.

Overall, as exhibit 21 shows, this is an operation that has benefitted from half a billion pounds of direct subsidy from the state since 2008 but that only amounts to an average of 35% of revenue from the state. If passenger revenue is exogenously determined by economic circumstance, here is a private company with a direct interest in increased state subsidy.

### 3. TOC walks away: First Greater Western

The third outcome is to walk away and this is particularly appealing for franchisees which are caught by cyclical down turn and/or have won franchises with bids that back loaded the premium payments in ways that make profit taking easy in the early years of the franchise and premiums onerous in the last years of the franchise. Both problems were relevant in the case of the Greater Western franchise. This was formed in April 2006 by the amalgamation of routes previously run by three smaller TOCs, Wessex Trains, First Great Western Link (aka Thames Trains) and First Great Western because policy makers wished to reduce the number of TOCs - particularly those running in and out of London – and increase coordination (ironic given the initial rhetoric of choice and competition at the beginning of privatisation)<sup>66</sup>. As their overall franchise was near identical pre-2006, the financial results of the three separate companies are included in the analysis presented here to gauge trends and trajectories since 2005 as well as results from 2007-2011 when First Group ran the enlarged franchise.

**Exhibit 22: First Greater Western –financial performance<sup>67</sup> (2012 prices)**

	Total private revenue	Direct State subsidy <sup>68</sup>	Pre-tax profit	Tax	Net profit	Dividends
	£m	£m	£m	£m	£m	£m
2005	674.7	102.5	70.1	21.0	49.1	35.4
2006	708.7	77.1	67.5	19.9	47.6	0.0
2007	710.1	114.5	22.9	6.8	16.2	16.0
2008	741.5	55.8	12.3	3.4	8.8	0.0
2009	806.5	64.4	-14.2	-3.8	-10.4	0.0
2010	773.1	144.5	7.8	2.5	5.4	0.0
2011	786.1	145.8	-56.1	-12.8	-43.3	0.0
2005-2011	5,200.7	704.7	110.3	37.0	73.3	51.4
2007-2011	3,817.3	525.0	-27.3	-3.9	-23.3	16.0

We can begin (fairly predictably) by considering how risk capital exposure was limited. First Group did not put any direct new capital into the new Greater Western franchise. Instead, it used accumulated reserves of some £10m from its wholly owned First Greater Western Link and First

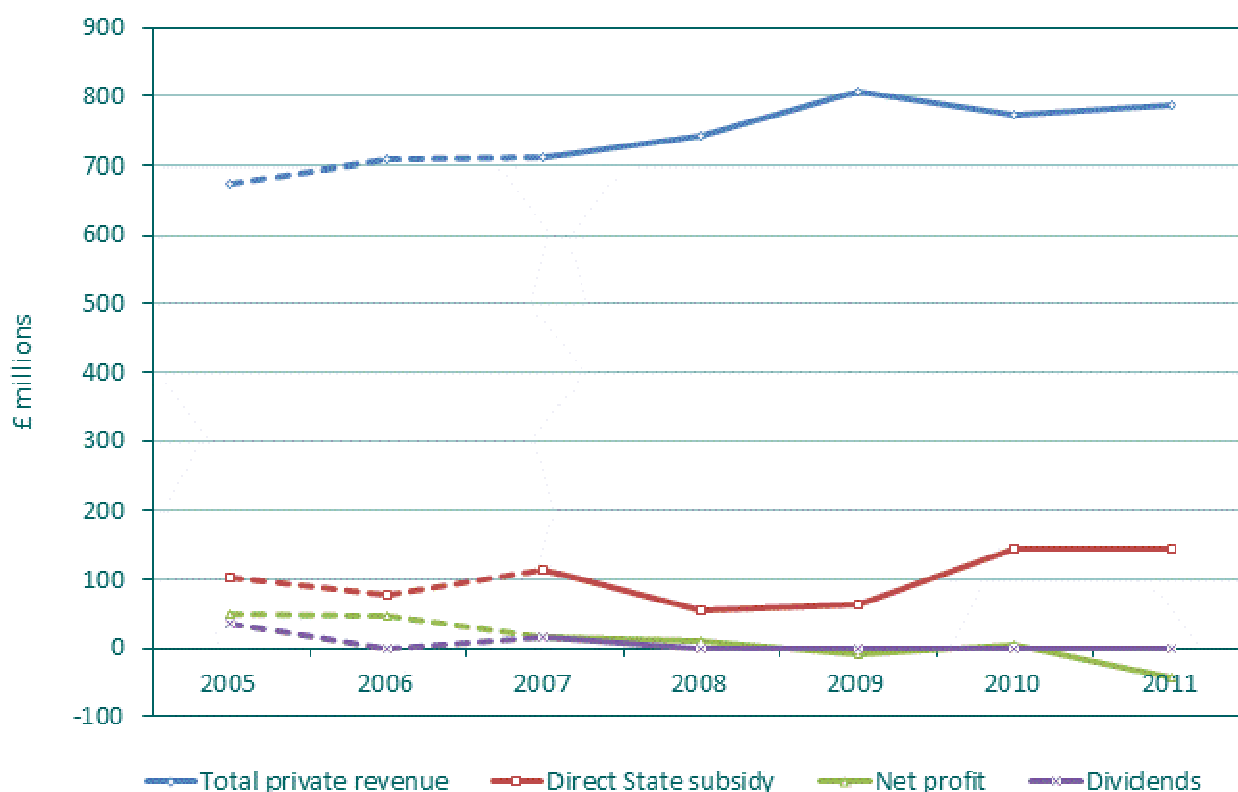
<sup>66</sup> The TOC is called First Greater Western, though it incorporates the old First Great Western franchise and hence is sometimes referred to as *First Great Western*. We have used the current name for the amalgamated TOC, *First Greater Western*, in this report.

<sup>67</sup> Source: Annual report and accounts, various years. Note: 2005 and 2006 data relates to First Great Western Link, Great Western Trains Co and Wales & West Passenger Co. These individual franchises combined in 2007 as First Greater Western.

<sup>68</sup> Note: The table refers to gross direct subsidy and therefore excludes franchise payments.

Great Western subsidiaries. Both were highly profitable after state subvention and the profits had not been entirely distributed so the risk capital was effectively the state's gift. As exhibits 22 and 23 show, First Greater Western's first year, 2007, was successful with (in 2012 prices) a net profit of £16.2m earned from private revenue of £710.1m and state subsidy of £114.5m. In line with extractive practice, the subsidiary took all this profit out immediately and paid its parent a £16m dividend.

**Exhibit 23:** First Greater Western: revenue, direct state subsidy<sup>69</sup>, net profit and dividends<sup>70</sup> (2012 prices)

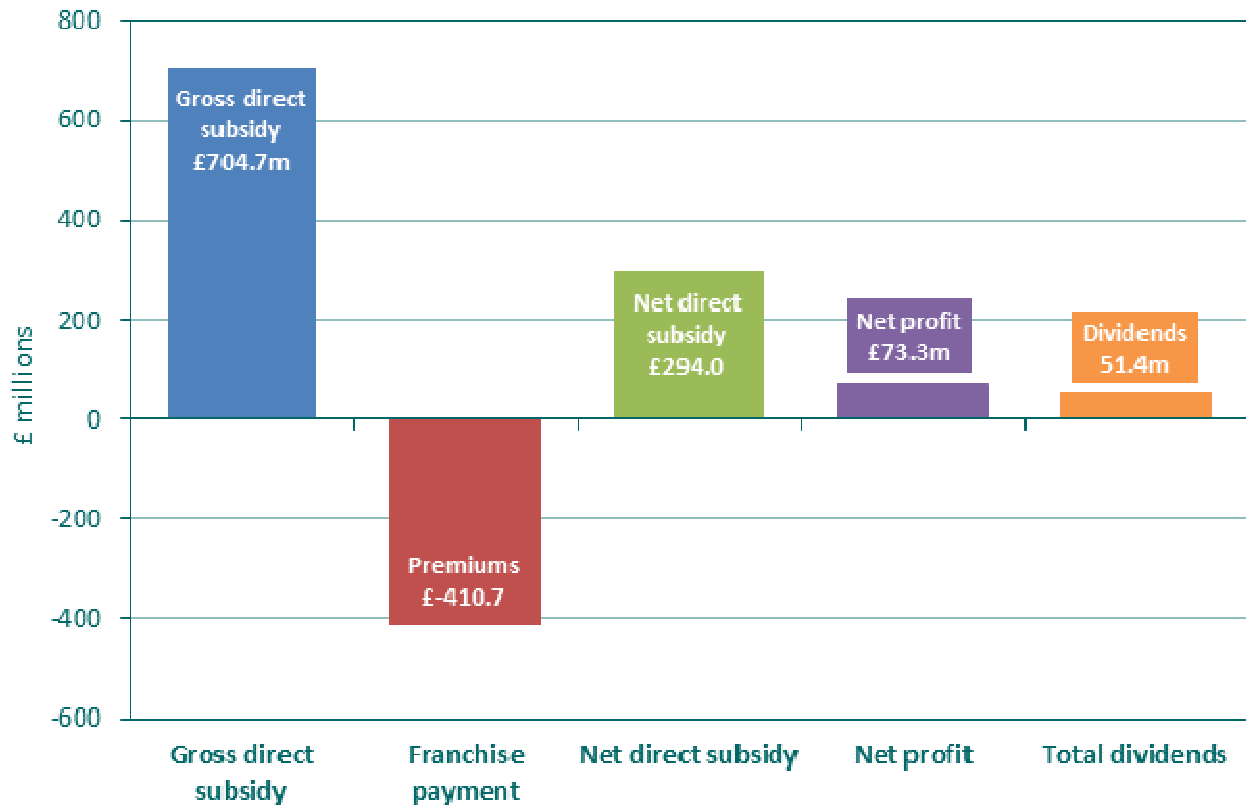


The following year, 2008 was also moderately profitable but then, with the onset of the recession, things start to go wrong as revenue growth slowed but franchise premiums began to rise sharply because (as we shall show in chapter 5) the premiums were heavily backloaded and 75% of the premium payments were due in the last three years. Despite the rise in state subsidy as shown in exhibit 23, by 2011 First Greater Western was making a loss. But, First Greater Western's franchise was for 10 years, with a break clause at seven years which allowed the DfT to drop First Greater Western if they were not satisfied, or vice versa. With three years still to run, First Greater Western walked away and avoided, according to press reports, £800m due in premium payments.<sup>71</sup>

<sup>69</sup> Note: The graph refers to gross direct subsidy and therefore excludes franchise payments.

<sup>70</sup> Net profit and dividends are paid after all payments including any franchise payments.

<sup>71</sup> The Observer, 13<sup>th</sup> March 2011. <http://www.guardian.co.uk/business/2011/mar/13/firstgroup-may-abandon-first-great-western-franchise>

**Exhibit 24: First Greater Western direct gross subsidy<sup>72</sup> vs. extraction 2005-2011 (2012 prices)<sup>73</sup>**

If we consider the First Greater Franchise after 2006, it only paid dividends in one year but over the whole 2005-2011 period the franchise (mostly owned by First Group), as exhibit 24 shows, paid out £50 million in dividends and built up retained earnings of around £21 million which is the owner's stake in the business. The next franchise operator – which now will not take over the line until 2016 due to the disarray in the franchising system – inherits an untransformed business with high labour share of value added and as much dependence on state subsidy as when it was fragmented. What First Greater Western shows is that franchising has become a game where franchisees cannot lose seriously.

This should be a cause for public concern because (as discussed further in chapter 5) back loading of premium payments has been common as a way of winning. The contracting state's response has been limited to fiddling with the modest penalties for walking away, and it seems completely incapable of recognising how the habitat created by the franchising system enables value extraction by the likes of First Group, and incapable of dealing with the behaviour by rejecting such bids or imposing terms and conditions (such as profits claw back) which would deter the behaviour. As we noted in the introduction and will consider in greater detail below, the First Group bid for the West Coast Main line (which failed on a technicality) has the same premium bid profile as three previously successful bids where the franchisees walked away in mid franchise after projecting large payments premiums in the later years of the contract.

<sup>72</sup> See footnote 59.

<sup>73</sup> *Ibid.*

## Chapter 3 – The habitat of value extraction: the ROSCOs and ‘every ticket wins’

### Charge 1 Privatisation created a habitat for value extraction at the public expense where the ROSCOs find ‘every ticket wins’

The sector wide result of privatisation is a habitat within which risk and investment averse private companies position themselves as *value extractors* who claim cash that comes indirectly from high public subsidies (with government taking the operating risk and supplying investment funds).

The ROSCOs do deliver a trickle of investment at state expense and at a high price under a lottery where ‘every ticket wins’. Their high profits at no risk comes through a value extraction process that has led to a decade of public criticism but only very modest reform.

Many rail passengers do not realise that the TOCs do not on the whole own their brightly liveried trains which are leased from a small number of rolling stock companies known as ROSCOs. But the high profits of all the ROSCOs are easier to understand than the variable profits of TOCs and the result has been more than a decade of sustained official criticism by the National Audit Office, the ORR, the Strategic Rail Authority, the Competition Commission and others.

As we have demonstrated, train operators play in a casino where the odds are stacked against the house (the tax payer) and a substantial number of TOCs play a game know they cannot lose. The rolling stock leasing companies have bought tickets in a very unusual kind of lottery where every ticket wins. In ordinary lotteries, there are a large number of tickets and a small number of winners but in this caucus race variant of a lottery, there are a small number of tickets and every ticket wins. This chapter tells the story of how the imaginary about the benefits of market competition created this outcome and continues to inhibit reform.

### **From the imaginary to low risk and high profits**

ROSCOs were ostensibly created, as with so much else in privatised rail, to increase competition and reduce barriers to entry in the operating franchises. Trains typically have a lifespan of more than 25 years and franchises have typically lasted for less than ten years. TOCs would surely refuse to bid for franchises if they had to make a substantial up-front investment in rolling stock which then had to be disposed of in a distress sale at end of franchise. So, separate rolling stock companies would take the risk on instead and lease to successive franchisees over the lifespan of the vehicles.

How the system *should* work, was summed up by the Competition Commission in their 2009 report on the ROSCOs (discussed further below):

*In a well-functioning market, TOCs would have the ability to choose between a variety of different fleets, and they would be able to switch freely between them or to invest in new rolling stock, depending on relative rentals, operating costs, and revenue-earning capacity. This process of TOCs choosing between fleets on the basis of perceived value for money would create competition on rental rates between different fleets, including existing and new rolling stock, taking account of each fleet's relative utility, i.e. their costs and revenue-earning capabilities. Lease rates would be determined by the balance of supply and demand for particular types of fleet but we would expect that in the long term as older rolling stock was retired from service, or if demand for rolling stock increased, rental rates would increase due to demand exceeding supply until a point where new rolling stock became a viable alternative, as new rolling stock is the only potential source of additional supply.<sup>74</sup>*

The imaginary is of an efficient market where supply and demand balances, prices accurately reflect values, choice is unlimited, information is perfect and everyone gets the best deal possible. This kind of generic vision of how the market should work underpins most government promises about the privatised rail system, but the outcome, as the Competition Commission found, is very different. The 'market' for rolling stock does not work as in the world of textbook economics because of the characteristics of the rail industry.

On privatisation, the 11,250 trains, with an average age of 16 years, which comprised the British Rail rolling stock were divided up and sold off to three leasing companies. It was hoped that a surge of capital market investment in new rolling stock would follow as the ROSCOs competed to offer the best vehicles possible to demanding TOCs.<sup>75</sup> The sector was to be run entirely by private finance, with no state responsibility for funding new rolling stock, and thus ROSCOs would be unregulated aside from competition law.

Train leasing is much less hazardous than aircraft or auto leasing. Ordinary commercial losses arising from lessee default are a significant problem in aircraft leasing. But lessor risk on trains was limited by state guarantee. If a franchise holder abandoned the lease, the government, via the rail regulator, would – as it acted to keep the trains running – take the franchisee's place, guaranteeing 80% of their cash flow from the lease.<sup>76</sup> In auto leasing of new cars lease rates are set on *ex ante* assumptions about the resale value of used stock so that optimistic predictions about resale values can crystallise in large losses. This risk on second hand values was again irrelevant in train leasing.

From the very start it was clear that rolling stock was to be a low risk leasing activity, but the privatisation auction of rolling stock did not raise as much as might have been hoped. The stock had a book value of £2.93bn but its sale in November 1995 raised just £1.8bn from three management buyouts that were later criticised by the National Audit Office (NAO) for underestimating the ROSCOs revenues. As in the case of TOC buy outs, the ROSCO buy out companies were quickly sold

<sup>74</sup> Competition Commission (2009), *Rolling Stock Leasing Market Investigation*, p.6. Available at <http://www.competition-commission.org.uk/our-work/directory-of-all-inquiries/rolling-stock-leasing-market-investigation>

<sup>75</sup> Shaoul, J. (2007) 'Leasing passenger trains: the British experience' *Transport Reviews*, Vol. 27, No 2, 192

<sup>76</sup> McCartney, S. and Stittle, J. (2012), 'Engines of Extravagance': The privatised British railway and the rolling stock industry' *Critical Perspectives on Accounting* 23 (2012), 155-8. Office of Rail Regulation (1998), *Review of the rolling stock market: report to the deputy prime minister*. Available at <http://www.rail-reg.gov.uk/upload/pdf/64.pdf>

on as management cashed out and took more than £750 million in profit. All three leasing companies had been re-sold by December 1997 for £2.6bn – costing the taxpayer £1.1bn in lost proceeds according to the NAO.

The three ROSCOs have since changed hands several times and ended up under the ownership of major banks.<sup>77</sup> They have, as Christian Wolmar has argued, ‘a license to print money’.<sup>78</sup> And they are certainly the single most profitable part of the railway with 40% or higher operating profit margins for much of their existence. The story of the ROSCOs is about how bad state decisions and the specifics of the sector came together to deliver not new rolling stock but a great opportunity for value extraction through contract.

Competition between the ROSCOs was stymied from the start by the lack of interoperability. Trains could not be switched seamlessly between franchises because of the patchwork nature of twentieth century electrification and nineteenth century loading gauge variation in clearance under bridges and around corners. At worst, electric locomotives were suitable for use on only 9% of the network. Even if some trains were interoperable, there was not enough surplus stock to generate competition – as noted by the NAOs 1998 report into the market.<sup>79</sup>

Matters were then made worse by the state’s choice of leasing model where the government rejected the aircraft industry practice of cheap leases for obsolescent and fully depreciated older units. The initial lease charges – which paved the way for future pricing models - were inflated due to the government choosing to value the rolling stock using modern equivalent asset pricing rather than depreciated book value, thereby increasing the nominal capital base and ROSCO requirements for profit and lease rates. The government also initially set charges for old trains at only a small discount to new trains in order to encourage TOCs to use newer trains rather than renting older ones cheaply.<sup>80</sup>

The ROSCOs were now to supply new trains but these were to be predominantly funded not from the capital markets but from hefty lease revenues paid by the TOCs on all their rolling stock including clapped-out ex British Rail units. The revenue to buy new trains would come from TOCs which, particularly in the early years of privatisation (before subsidy was redirected through Network Rail) were heavily dependent on state hand-outs. Thus, the taxpayer and fare-payer was once again footing the bill.<sup>81</sup> And, as we argue below, the inflow of capital from the markets never happened because the ROSCOs had a cost plus (extravagant mark-up) relation to the state.

High lease charges could yet have generated a substantial investment fund for new rolling stock (albeit at taxpayer expense) if the ROSCOs had reinvested their profits. But fatally, the ROSCOs were completely unregulated in terms of any obligation to reinvest profits. So the result was a

<sup>77</sup> Shaoul, J. (2007), ‘Leasing passenger trains’, p.193, McCartney, S. and Stittle, J. (2012), ‘Engines of Extravagance’, p. 164-5.

<sup>78</sup> McCartney, S. and Stittle, J. (2012), ‘Engines of Extravagance’, 162-3; and Crompton G. and Jupe, R. (2004), ‘A Deficient Performance?’ The Regulation of the Train Operating Companies in Britain’s Privatised Railway System’ Canterbury Business School Working paper number 66.

<sup>79</sup> Yvrande-Billon and Menard, 2005, in McCartney, S. and Stittle, J. (2012), ‘Engines of Extravagance’, p. 157, National Audit Office (1998) *Privatisation of the rolling stock leasing companies*. Available at <http://www.official-documents.gov.uk/document/hc9798/hc05/0576/0576.pdf>

<sup>80</sup> Shaoul, J. (2007), ‘Leasing passenger trains’, p.195.

<sup>81</sup> Shaoul, J. 2007, ‘Leasing passenger trains’, p.210.

classic value extraction three-step at the expense of the contracting state: in step one, government subsidy goes into one company such as a TOC; in step two, the subsidy is transferred to a second company via a quasi-market transaction such as a lease payment to a ROSCO; in step three, the second company takes a substantial part of the lease payment as profit so that state subsidy can be distributed to private shareholders.

Just as predictably, if the chain comes apart (e.g. through failure or withdrawal of a TOC) the lease company's value extraction is guaranteed by the state. As the operator of last resort under the 1993 Railways Act, the government provides a guarantee that the lease will be fulfilled. In this world of politically constructed profit, the risk on train leasing is thus a political risk rather than a commercial risk of default such as arises in aircraft or a residual value risk as in auto leasing. Even if a TOC halted operations overnight, the lease would be fully abandoned *only if the state decided to halt services* on a particular route and renege on its role of operator of last resort. As the failures of the National Express East Coast and Connex show, the state will always step in because the wider economic and political damage caused by a closure of the line would (in almost all circumstances) be too great to bear.

### **And what did we get in return?**

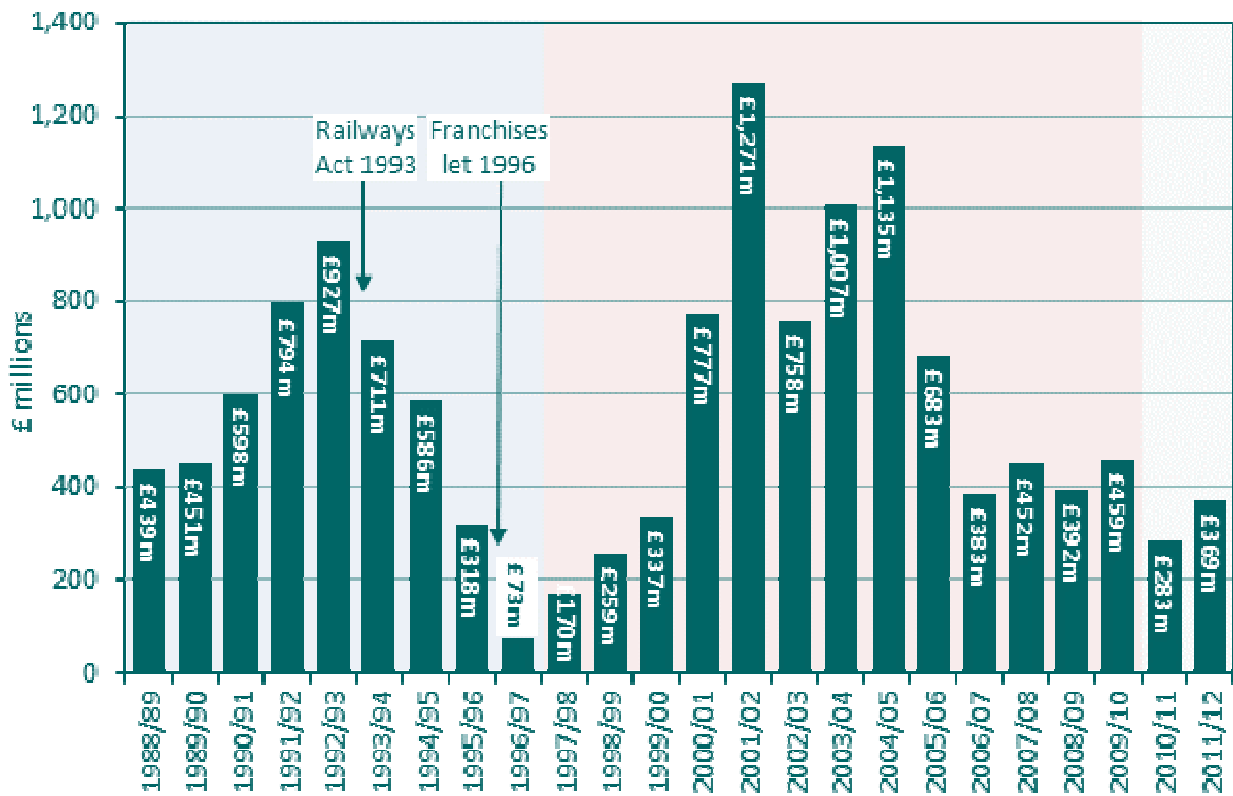
With the ROSCOs completely unregulated in terms of obligations to reinvest profits, the boom in new rolling stock orders (which the government had promised) failed to materialise, with even the years of highest profitability for the ROSCOs seeing low levels of capital spending in rolling stock.<sup>82</sup> As exhibits 25, 26 and 27 show, there was a spike in new orders in the early 2000s partly explained by the requirement to replace outdated slam-door carriages; but, overall, rolling stock orders have been highly volatile and, over the past five years, lower than pre-privatisation. Even after the UK economy entered recession in 2008, passenger numbers continued to increase so that a downturn in investment could not be justified on the basis of reduced passenger demand. Moreover, in the previous downturn in the early 1990s investment was not reduced in the same way, as exhibit 25 shows. There are clearly several determinants of investment in any period but it does not seem to be the case that privatisation has led to any sustained increase in investment.

The hidden corollary damage of volatile and sometimes very low investment has been the near collapse of the British train building industry which could not be sustained on this erratic, unplanned low volume. Here again is a nice illustration of our key point that the main issue is not the amount of value extracted – egregious though that was in the case of the ROSCOs – but the collateral, and often irreversible, damage to the broader public interest. And here again is the contracting state failing to protect the public interest because the sectional pursuit of profit and point value by privatised corporate customers and users of rail engineering products was not balanced against the national interest in the maintenance of capability and employment in the rail engineering supply chain.

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<sup>82</sup> McCartney and J Stittle (2012), 'Engines of Extravagance', p.161-3.

**Exhibit 25: Investment in rolling stock<sup>83</sup> (£m, 2012 prices)**



**Exhibit 26: Investment in rolling stock: the last five years (2008 – 2012) compared to the five years before privatisation (1989 – 1993)<sup>84</sup> (£m, 2012 prices)**

State rolling stock investment five years before privatisation		Private (but state guaranteed) rolling stock investment over the past five years	
	£m		£m
1989	439	2008	452
1990	451	2009	392
1991	598	2010	459
1992	794	2011	283
1993	927	2012	369
<b>Total 1989-1993</b>	<b>3,209</b>	<b>Total 2008-2012</b>	<b>1,955</b>

The British rail engineering industry was seriously damaged by the decisions of its privatised purchasers; and this story is of course replicated in the other supply chains in British heavy engineering which supplied downstream privatised utilities. The design and build competence of nationalised British Rail Engineering (BREL) was broken up when it was privatised in 1989. BREL facilities were divided between several multinationals at different sites who then played pass the

<sup>83</sup> Office of Rail Regulation (ORR).

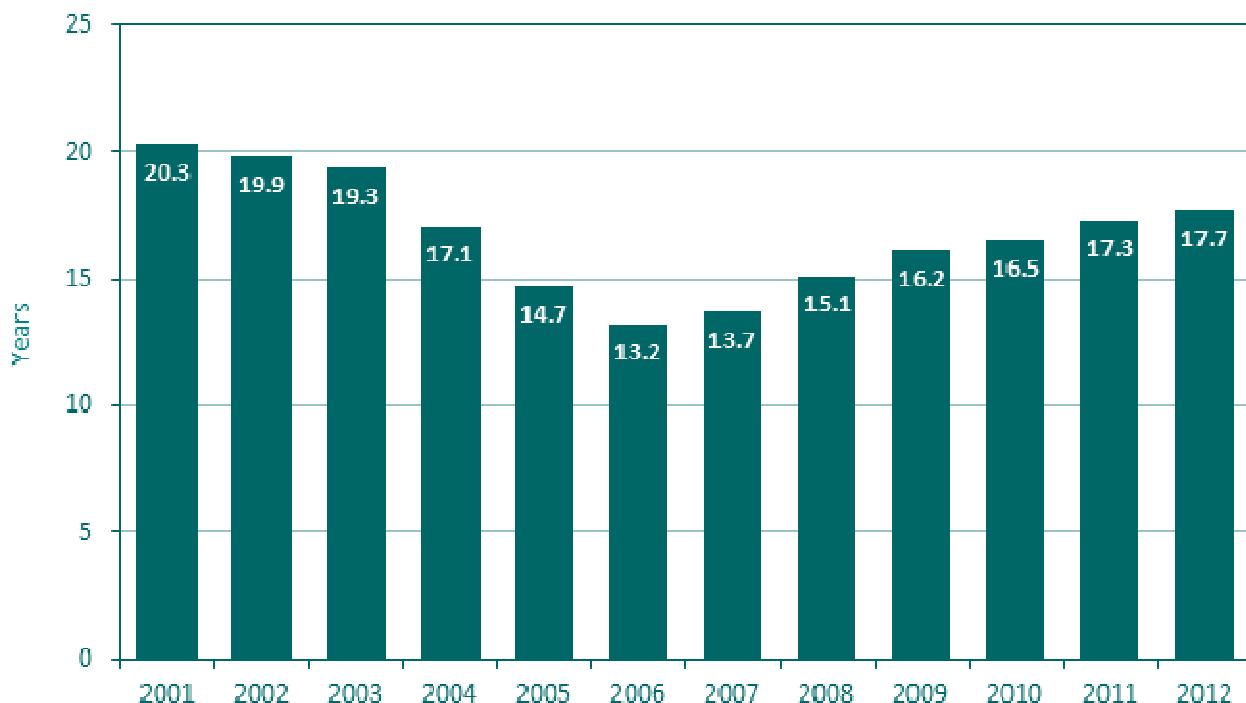
<sup>84</sup> Source: ORR.

parcel with British branch factories. The central Derby BREL factory had five changes of ownership and at least three changes of (foreign parent) management systems and corporate objectives over the next 12 years.<sup>85</sup>

The York and Washwood Heath factories had already closed by 2011 when the last remaining facility at Derby was threatened with closure.<sup>86</sup> The occasion was the award of a train building contract to Siemens, Krefeld not Bombardier, Derby on the basis of best value calculations that we criticised at the time because they bundled train finance, construction and maintenance.<sup>84</sup> If Siemens access to cheaper finance was the occasion, the fundamental cause of Bombardier's misfortunes was the behaviour of the ROSCOs which had undermined the flow of orders and led to the closure of most of the British rail engineering industry.

This complex back story about broken supply chains may have gone largely unnoticed by a British public increasingly accustomed to buying other high-tech goods from overseas; but, what the fare payer did notice was that (s)he was still much of the time riding in old rolling stock. As exhibit 27 shows, the average age of rolling stock decreased following large orders placed from 2000-2002. This was not the magic of private enterprise working because a £4.2bn investment programme and the 2001-02 orders spike was driven by statutory obligations to replace slam-door trains and the imposition of new franchise conditions. When the regulatory impetus was removed new investment and deliveries of rolling stock fell away again. So the average age of rolling stock has since risen again to over 17 years which is older than during the final years of British Rail. For long distance trains the average age is older still at 21.19 years.

**Exhibit 27:** Average age of UK rail rolling stock (years)



<sup>85</sup> Froud *et al.* (2011), 'Knowing what to do? How not to build trains' *CRESC Research Report*. Available at <http://www.cresc.ac.uk/sites/default/files/Knowing%20what%20to%20do.pdf>, p. 14.

<sup>86</sup> *Ibid.*

Averages of system-wide age of rolling stock can be misleading. They certainly obscure more localised problems where some operators on main line or major commuter routes are still using completely outdated and dilapidated British Rail rolling stock. First Great Western, for example, runs from Paddington to serve the M4 commuter corridor, Bristol and Wales. The average age of Great Western rolling stock is 28.7 years, the oldest in the country leaving aside the anomalies of the Isle of Wight and Merseyrail which get by on cast-offs. The Great Western service is running diesel powered British Rail Engineering InterCity 125s which initially entered service in 1976 and will not be replaced until after 2017 (if the current upgrade project runs on schedule).

The passenger's chance of getting a seat is also diminished because passenger numbers have gone up but the number of carriages has not. Public data is not available on the matter, but a Competition Commission report in 2009 said that while passenger traffic had risen by 60% since 1994/5, there had been only a 3% rise in passenger vehicles in operation since privatisation.<sup>87</sup> A substantial number of new orders had been placed in the early 2000s when slam door stock was replaced, but most of this investment was like for like replacement which did not create extra seating capacity or anticipate the significant increase in passenger numbers.

This dismal tale of economic mirage and political folly can be rounded off by making two supplementary points. First, we have told the story of the ROSCOs as best we can from available sources, but much essential public interest information is not in the public domain. Second, effective reform is slow to come despite the accumulation over more than a decade of successive official reports which repeat many of the same charges.

While the large profits made by the ROSCOs are visible in their filed accounts, the leasing contracts between the ROSCOs and the TOCs are 'commercially confidential' so it is not possible to get an accurate picture of what rates they charge for different types of vehicle.<sup>88</sup> Confidentiality suits the ROSCOs because, as other authors have suggested, outsiders cannot then prove that they charge excessively for vehicles which are already amortised.<sup>89</sup> According to Jean Shaoul's analysis, ROSCO lease charges typically recover 75% of the cost of their new trains within five years, which is well within a standard franchise period. The implication is that the TOCs (and by extension the taxpayer and the fare payer) continue to pay for the vehicles long after the ROSCOs have covered their initial outlay.<sup>90</sup> The public interest in this issue is considerable since rolling stock costs make up 15% of total rail industry costs and leases account for 8% of costs, according to the McNulty report.<sup>91</sup>

The repetitive nature of public criticism in successive reports and the survival of old problems and unreformed behaviours is another important theme because the system has remained essentially unchanged in structure since privatisation. The 2009 Competition Commission report into the rolling stock market provides the most detailed official investigation to date. It cleared the ROSCOs

<sup>87</sup> Competition Commission (2009), *Rolling Stock Leasing Market Investigation*, p. 5.

<sup>88</sup> The Competition Commission failed to find a means of determining whether lack of competition was leading to higher profits for the TOCs, but did find that 'in general' margins were higher on MOLA stock (ex BR) than on new vehicles.

<sup>89</sup> McCartney, S. and Stittle, J. (2012), 'Engines of Extravagance', Shaoul, 'Leasing passenger trains'

<sup>90</sup> Shaoul, J. 'Leasing passenger trains', p. 208.

<sup>91</sup> McNulty, R. *et al.*, (2011) *Realising the Potential of GB Rail*, p. 229. According to Jean Shaoul's estimates rolling stock accounted for 16% of TOC operating expenditure in 2003, later estimates by McCartney and Stittle state that the ROSCOs account for 20% of the TOCs expenses.

of collusion in price fixing and identified the persistence of problems which have existed since the early years of privatisation, namely that 'TOCs had limited ability to threaten credibly to refuse to do business with any ROSCO'. Furthermore, as long as there was a code of conduct obligation on ROSCOs to offer all TOCs the same prices, then TOC efforts to drive down the prices in the tendering process were limited since rebates would confer no competitive advantage.<sup>92</sup>

The Commission found that effective competition was prevented and, in 64% of leases, no competitor fleets had been proposed in the TOCs franchise bids. The fundamental constraint was low levels of stock substitutability (different franchises require trains with different speeds, capacity and adaptation to track and stations) and high costs of switching which included driver training. The practical limit was that the amount of unused rolling stock available from all the ROSCOs never rose above 4% of the total fleet and much of this surplus was 'close to or beyond the end of its originally estimated economically useful life'.<sup>93</sup> As before, very little shopping around was taking place because there was almost nothing on the shelves in the first place.

The findings of the Competition Commission report in 2009 were neither new nor surprising. The NAO in 1998 had concluded that the system was not competitive and that leases had been overpriced; the ORR in the same year stated unambiguously its belief that the ROSCOs had significant market power; the Strategic Rail Authority in 2003 said 'TOCs will often have little or no choice of supplier' and found that the new trains provided by the ROSCOs were unreliable;<sup>94</sup> the 2004 *Future of Rail* White Paper questioned whether the ROSCOs were supplying value for money and admitted that 'assumptions made at the time of privatisation' about ROSCO willingness to take risk 'have not generally come to pass'. The NAO reported in 2004 that underinvestment in rolling stock was leading to overcrowding on many routes.<sup>95</sup> And the 2009 Competition Commission report itself stemmed from concerns raised by the ORR and the DfT in 2006-7 that the system was uncompetitive and characterised by over-charging of the TOCs.<sup>96</sup>

Despite this, moves towards reform have been timid partly because regulators and policy makers have been reluctant to control prices. Even the Competition Commission's modest reform proposals have not been acted upon. The DfT can oblige a TOC to lease or invest in new rolling stock or refurbishments as part of its franchise agreements, but the DfT crucially cannot intervene in the lease price which is subject only to competition law. The Competition Commission decided against price controls in favour of limited measures to increase transparency and improve conduct – exactly the same kinds of proposals put forward by the SRA in 2003 when it too rejected the idea of price controls.<sup>97</sup>

<sup>92</sup> Competition Commission (2009), *Rolling Stock Leasing Market Investigation*, p. 10-11.

<sup>93</sup> Competition Commission (2009), *Rolling Stock Leasing Market Investigation*, p. 8-9.

<sup>94</sup> Strategic Rail Authority (2003) *Rolling Stock Strategy December 2003*. Available at <http://webarchive.nationalarchives.gov.uk/+http://www.dft.gov.uk/consultations/archive/2003/ingstockstrategyconsult1482.pdf>

<sup>95</sup> National Audit Office (2004), *Improving passenger rail services through new trains*. Available at [http://www.nao.org.uk/publications/0304/passenger\\_rail\\_services.aspx](http://www.nao.org.uk/publications/0304/passenger_rail_services.aspx)

<sup>96</sup> ORR, *The leasing of rolling stock for franchised passenger services ORR's reasons for making a market investigation reference to the competition commission* (26 April 2007). McCartney and J Stittle (2012), 'Engines of Extravagance', p. 161.

<sup>97</sup> Shaoul, J. (2007), 'Leasing passenger trains, p. 198.

As long as the imaginary about markets and competition dominates, prices cannot be fixed even when the material specificities of rail mean that there is no competition. But there is now some very slow movement. The McNulty Review focused on excessive re-lease rates and recommended DfT partnership with ROSCOs backed by the threat of price controls.<sup>98</sup> Meanwhile, government policy engages the rolling stock problem via longer franchises, which it claims will reduce risk and encourage investment from both TOCs and ROSCOs. More constructively, the DfT is bypassing the ROSCOs altogether with major new orders.

For Crossrail, Thameslink and the new Intercity Express Programme the government has led a process of direct procurement from the manufacturers. In the new procurement system, manufacturers and financiers create an SPV which owns the trains and leases them to the franchisee, with the government as before guaranteeing the continuity of the lease over different franchise periods.<sup>99</sup> 2,100 new carriages are to be introduced to the network by 2019 via 'agreements' between the TOCs and the DfT.<sup>100</sup>

This bypassing of the ROSCOs is a constructive and significant development in itself and because it could serve as a pattern for evicting other useless intermediaries with a taste for value extraction. The Association of Train Operating Companies has estimated that even in a scenario of high growth in passenger numbers and new rolling stock orders, government led procurements for Thameslink, IEP and Crossrail will account for almost half of all the new fleet introduced. In ATOC's low growth scenario, they account for more than 75%.<sup>101</sup>

If the ROSCOs are thus increasingly irrelevant to the provision of new rolling stock, they are still earning nicely from the existing fleet. In their Alice in Wonderland world where every ticket is a winner, the ROSCOs are the Cheshire cats who are now very slowly disappearing until they leave nothing behind except a grin.

## Chapter 4: Network Rail enabling a charade and storing up problems

### Charge 2: Network Rail enables the charade by low track access charges which depend on public subsidy

Network Rail has lowered its track access charges in an opaque politically led process that provides an undisclosed indirect subsidy which props up the TOCs profitability and stores up problems in the form of £30 billion accumulating debt on the Network Rail balance sheet.

<sup>98</sup> McNulty, R. *et al.*, (2011) *Realising the Potential of GB Rail*, p. 236-7.

<sup>99</sup> The latter is being run as a PPP with the DfT specifying the requirements for the new trains and the Agility Trains consortium delivering the vehicles - all without ROSCO involvement. McCartney and J Stittle (2012), 'Engines of Extravagance', p. 161. See also Foster A (2010), *A Review of the Intercity Express Programme*. Available at <http://assets.dft.gov.uk/publications/review-of-the-intercity-express-programme-by-sir-andrew-foster/report.pdf>

<sup>100</sup> DfT, 'Press release: Additional seats for Leeds commuters'. Available at <http://www.wired.gov.net/wg/wg-news-1.nsf/0/3F00D547C3B56C4D802578710031844B?OpenDocument>

<sup>101</sup> ATOC (2011), *Rolling stock requirements 2014-2019: An ATOC Overview*. Available at [http://www.aTOC.org/clientfiles/File/ATOC%20Rolling%20Stock%20Strategy%20-%20Final\\_1.pdf](http://www.aTOC.org/clientfiles/File/ATOC%20Rolling%20Stock%20Strategy%20-%20Final_1.pdf)

Infrastructural investment in rail is being publicly funded; while the TOC contribution to operating costs through track access charges have been falling even as they use the infrastructure more.

The twenty-year history of privatised British Railways is not just an omni-shambles but a serial shambles. As one set of structural contradictions and corporate behaviours drives towards a denouement, this does not bring resolution but rearranges the unsolved problems in a slightly different configuration which stores up more trouble. So it was with the collapse of the PLC infrastructure company Railtrack, which went into administration in autumn 2001. The New Labour replacement for Railtrack was the not for dividend company Network Rail which was differently operated and financed so that (as we shall see) it created a comfortable new habitat for the TOCs at the price of its own medium term financial sustainability.

This serial shambles is more cock-up than conspiracy but it is of course a very British cock-up embedded in a form of post 1979 politics where the political classes defer to corporate interests. A multiplicity of different cock-ups then has predictably similar economic results in that the outcome usually advantages the corporate sector at the expense of the taxpayer. Thus, Network Rail, at the behest of the ORR and the DfT, has held down track access charges which dramatically improved TOC profitability and increased the amount that TOCs could distribute; at the same time Network Rail has financed investment by accumulating publicly guaranteed debt which both stores up problems for the tax payer and burdens the company with interest payments to bondholders.

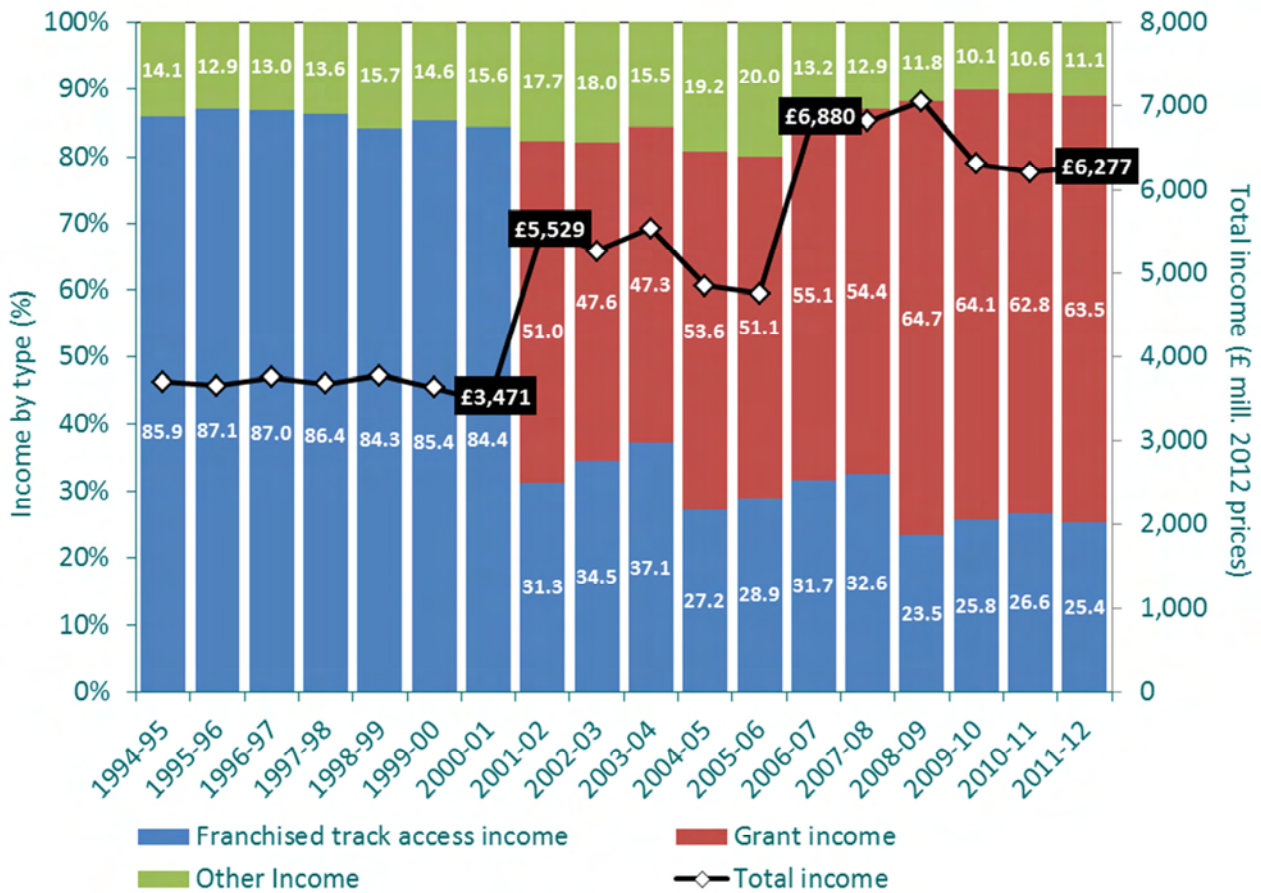
The political effects of cock-ups are much more variable and unpredictable, but in this case were wholly positive for the political classes and the TOCs as the major surviving corporate players. The collapse of Railtrack should have discredited the imaginary about private enterprise which had been used to justify privatisation nearly a decade earlier. But the change of regime under Network Rail saved appearances and gave the imaginary a new lease of life. Privatisation apparently had not failed because the TOCs could now present themselves as self-reliant profit-earners, but that was thanks to low track access charges, which of course represented an undisclosed public subsidy at the expense of the taxpayer who paid for the charade.

To understand all this, we need to begin with some history and then turn to analysis of the Network Rail accounts.

## From Railtrack to Network Rail

The politicians, civil servants and bankers who planned rail privatisation always intended that the network of track, signalling and major stations should be owned, built and maintained by a separate infrastructure company. In the original Conservative 1992 White Paper on rail privatisation, the train operating services were to be franchised to private companies but the infrastructure was to remain publicly owned because there was no historical record or early prospect of profitability. But the power of the imaginary about the generic benefits of privatisation was such that it was decided to privatise Railtrack which was formed in April 1994, by floating the company on the stock exchange two years later in May 1996.

**Exhibit 28:** Railtrack and Network Rail share of income by type 1994-2012<sup>102, 103</sup>



The logic of the new system was full-cost high track access charges levied by the infrastructure company on the TOCs. Railtrack was established to run without direct public subsidy and in a kind of ideal privatised system. Ideally, the TOCs’ track access charges would provide a rental income which covered costs of routine maintenance and renewal of infrastructure while Railtrack would tap the capital markets to provide for major new infrastructure investments. As the TOCs’ use of the network increased with more passengers and more trains on better quality infrastructure, so track access charges would increase. (And government need not enter into the equation). As exhibit 28 shows, this ideal looked plausible in the early years of privatised rail when more than £2 billion, or some 85% of Railtrack’s total income, was raised from track access charges.

However, there were serious questions about whether this funding system was sustainable in the medium term. There never was enough passenger and freight revenue in the system to sustain an (inefficient) infrastructure company and the TOCs so that the whole system was immediately reliant on government subsidy, which was initially paid to the TOCs. Privatisation enthusiasts projected efficiency gains but these were unlikely when (as we shall see in chapter 6) British Rail had an exemplary operating efficiency record; thus the capital markets were unlikely to see much prospect of adequate returns from rail infrastructure. The reality was that, unless government subsidy was increased substantially, high track access charges would drive the TOCs into operating losses (and large scale handing back of franchises). The economic logic of the new system was a political fight

<sup>102</sup> Railtrack and Network Rail annual report and accounts, various years.

<sup>103</sup> Grants includes deferred grants and incentive adjustments.

to the corporate death over track access charges as the infrastructure company would go under unless it could levy high access charges, just as many TOCs would quit unless track access charges were kept low.

But pure economic logic never operates in this muddled, political world where the panic in 2001-2 and afterwards was about what to do when Railtrack suddenly collapsed after losing control of operations and safety. Some of these problems were only to be expected because large, integrated and publicly owned organisations like British Rail are well suited to the business of running complex systems which require technical and engineering led decisions, properly trained and controlled staff at ground level plus strict adherence to operating systems and safety procedures. The scale and consequences of the safety debacle at newly privatised Railtrack was nevertheless shocking and unexpected.

At first, all appeared to be going well in privatized Railtrack and the value added analysis in exhibit 29 explains why. Railtrack spent little on investment, outsourced almost everything and was running with a purchase to sales ratio of 65% or more in the mid and late 1990s. In other words, after it had paid its contractors and other internal expenses in the early years there was always a surplus which could be declared as profit and Railtrack impressed the stock market by distributing dividends to its shareholders. However, a succession of fatal rail accidents at Southall in 1997, Ladbroke Grove in 1999 and Hatfield in 2000 (and the subsequent inquiries) exposed the limits of the outsourcing policy which had left Railtrack without the necessary knowledge of, and control over, safety-critical areas of operations.

Panic ensued after Hatfield as Railtrack embarked on a massive programme of track upgrades and rail replacement while imposing temporary speed restrictions on existing track. Because Railtrack lacked in house expertise, Wolmar argues it replaced many rails unnecessarily and could not manage the consequences of speed restrictions; widespread delays discouraged fare paying passengers and meant Railtrack paid large fines to the TOCs. Railtrack began to make huge losses and was effectively wound up by the New Labour government. In 2001, its final year of operation, Railtrack received a £1.5bn government bailout; significantly, company accounts show it paid shareholders a £138m dividend while making a pre-tax £534m loss.

The New Labour government was not prepared to carry out its pre-1997 election promise to renationalise the railways, but instead took a third way decision to create a new not-for-profit infrastructure company. Network Rail was formed in October 2002 as a not-for-dividend limited liability private company with no shareholders. In legal terms, the company was private but an odd governance structure meant that Network Rail operated on the blurred boundary between the public and the private sectors.

From the beginning, government could appoint directors and control virtually everything Network Rail did through a complex web of regulation and monitoring. Having received direction from the secretary of state, the ORR at five year intervals sets out how much Network Rail should spend, what it should spend on and when, as well as dictating targets on efficiency, punctuality across the network and (crucially as discussed below) track access charges. Overall, the introduction of Network Rail brought with it a complete change of regime in terms of operations and funding. For

example, as outsourcing was completely discredited, Network Rail brought many routine operations in house where they could be better controlled.

**Exhibit 29:** Railtrack and Network Rail operating profile and distribution of value added, 1994-2012<sup>104</sup>

	Purchases to (sales or other) revenue <sup>105</sup> %	Labour's share <sup>106</sup> of value added <sup>107</sup> %	Depreciation share of value added %	Interest share of value added %	Pre-tax profit share of value added %
1994-95	69.4	41.2	13.4	18.2	27.2
1995-96	70.4	39.2	15.7	17.2	27.9
1996-97	68.2	35.4	16.0	4.0	44.6
1997-98	65.6	32.6	17.4	4.2	45.7
1998-99	44.5	20.7	44.4	5.0	30.0
1999-00	42.7	22.1	49.2	4.0	24.7
2000-01	65.6	42.5	109.8	10.5	-62.7
2001-02	117.4	-61.0	-72.6	-13.3	247.0
2002-03	87.0	55.8	42.7	32.2	-30.6
2003-04	84.7	96.2	106.4	53.1	-155.7
2004-05	35.6	45.0	33.8	26.0	-4.8
2005-06	25.4	44.6	33.3	30.2	-8.1
2006-07	13.0	27.5	21.3	22.2	28.9
2007-08	11.6	28.8	22.4	19.0	29.8
2008-09	14.5	31.2	22.6	17.8	28.5
2009-10	22.0	38.5	26.3	26.4	8.8
2010-11	17.8	35.0	25.7	30.3	8.9
2011-12	21.9	34.3	28.1	27.9	9.7
<b>Railtrack 1994-2001</b>	<b>60.5</b>	<b>30.9</b>	<b>40.9</b>	<b>7.9</b>	<b>20.3</b>
<b>Network Rail 2002-2012</b>	<b>35.9</b>	<b>37.5</b>	<b>29.3</b>	<b>25.8</b>	<b>7.3</b>

<sup>104</sup> Railtrack and Network Rail annual report and accounts, various years.

<sup>105</sup> The purchase to sales column measures the proportion of revenue that is used to buy in goods or services. A lower figure indicates greater vertical integration with many of the daily tasks conducted by Network Rail's employees.

<sup>106</sup> Labour's share, depreciation share, interest share and pre-tax profit share measure the proportion of value added distributed to each category. For example, labour's share of value added is measuring the proportion of the value added each year by Network Rail that is distributed as wages and salaries to its employees.

<sup>107</sup> Mathematically, value added is calculated subtractively, sales minus purchases. Technically it is a measure of the proportion of total revenue generated by Network Rail and not bought in.

As exhibit 29<sup>108</sup> shows, the amount spent on bought-in goods and service fell significantly: the purchases to sales ratio in exhibit 29 shows how bought-in goods and services fell from 60-80% in most years in the 1994-2004 period, to less than 25% in every year after 2005 as Railtrack sub-contractors were replaced with Network Rail employees. As a consequence, the size of the directly employed infrastructure workforce increased threefold so that Network Rail has employed some 35,000 workers in recent years. The labour-cost share of value added does not show a marked overall increase over this period because the value added increases as well as the internal labour costs.

At the same time, the government made an undisclosed change in the way that the infrastructure company was funded when Network Rail replaced Railtrack. Track access charges were effectively lowered and grant income, referred to as the Network Grant, was brought in. As exhibit 30 shows, whereas Railtrack had been 85% financed by track access charges, Network Rail is now no more than 25% financed by track access charges and the balance of its income comes mainly from government grants, which now amount to nearly £4 billion each year. In fact, the changes of funding were more radical than they appear in exhibit 28, because Network Rail was allowed to augment its operating income by borrowing for investment purposes in the capital market (with government guarantees of the debt).

This wholesale change in funding regime was the outcome of various decisions made in haste and under pressure by the Treasury, the DfT and the regulator. In the aftermath of the collapse of Railtrack, it was realised that the state would have to stump up more money to keep things going and it appears that the Treasury preferred to keep this spending out of the Public Sector Borrowing Requirement (PSBR). These decisions were never publicly explained and justified. Instead the sequence of events and decisions was hidden away in ORR documents which are not anywhere summarised, indexed or, indeed, made at all intelligible. Appendix A to this chapter presents the results of our research into the government archive and explains the motives and interventions which made higher track access charges politically inexpedient.

The broad logic of the new infrastructure funding regime, we infer, was that lower track access charges plus other forms of funding were less politically toxic than any other way of funding the necessary infrastructure expenditure. Higher track access charges would result in TOCs claiming compensating subsidies which would count in the PSBR; just as higher ticket prices would surely be

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<sup>108</sup> Notes: *Purchases* is the amount spent on bought-in goods and services. The purchase to sales revenue ratio expresses these external purchases as a percentage of sales. In general terms, outsourcing will tend to increase the purchase to sales ratio, while moving operations in-house will tend to reduce it. *Value added* is the residual after purchases have been deducted from revenue. It is the amount that is available for internal distribution to employees, for depreciation and to pay interest and dividends. *Labour's share of value added* is the percentage of value added distributed to the internal workforce. *Depreciation share of value added* is the percentage of value added allocated to the depreciation of fixed assets. Depreciation charges will increase when an organisation invests in new assets. *Interest share of value added* is the percentage of value added paid out as interest in net debt (i.e. debt less savings). This rises significantly during the life of Network Rail, for reasons discussed later in this chapter. *Pre-tax profit* is the residual after all of the above claims have been met. This is the sum from which dividends are paid.

politically unpopular. This political line of least resistance was publicly guaranteed private debt which (under public sector accounting rules did not formally increase public borrowing) did of course have major consequences for the TOCs and the taxpayer.

**Exhibit 30:** Railtrack and Network Rail's sources of income, 1994-2012<sup>109</sup>

	Franchised track access income		Grant income		Other Income		Total income £mill.
	£mill.	% of total	£mill.	% of total	£mill.	% of total	
1994-95	3,185	85.9	0	0.0	521	14.1	3,706
1995-96	3,186	87.1	0	0.0	472	12.9	3,658
1996-97	3,269	87.0	0	0.0	491	13.0	3,760
1997-98	3,180	86.4	0	0.0	501	13.6	3,681
1998-99	3,188	84.3	0	0.0	594	15.7	3,782
1999-00	3,104	85.4	0	0.0	531	14.6	3,635
2000-01	2,929	84.4	0	0.0	543	15.6	3,471
2001-02	1,731	31.3	2,818	51.0	980	17.7	5,529
2002-03	1,817	34.5	2,506	47.6	946	18.0	5,269
2003-04	2,056	37.1	2,622	47.3	861	15.5	5,539
2004-05	1,320	27.2	2,604	53.6	931	19.2	4,855
2005-06	1,376	28.9	2,431	51.1	953	20.0	4,759
2006-07	2,180	31.7	3,793	55.1	906	13.2	6,880
2007-08	2,224	32.6	3,711	54.4	883	12.9	6,818
2008-09	1,656	23.5	4,564	64.7	836	11.8	7,056
2009-10	1,630	25.8	4,051	64.1	636	10.1	6,317
2010-11	1,655	26.6	3,901	62.8	659	10.6	6,214
2011-12	1,593	25.4	3,989	63.5	695	11.1	6,277

## Lower track access charges and the charade of TOC independence

The privatised rail sector is, like other utilities, part of an enclosed world of politically constructed profit in two ways: first, the key decisions which advantage corporates have to be made by politicians, civil servants and regulators; and, second, the outcomes have economic and political effects in a broader sphere where appearances do matter. Track access charges fit into this world. First, they are not fixed commercially in any market setting but politically. The track access charges are determined by government at 5 year intervals called control periods. The government then sets a target rate of return<sup>110</sup> which Network Rail is allowed to get from its regulated asset base<sup>111</sup>. This

<sup>109</sup> Railtrack and Network Rail annual report and accounts, various years.

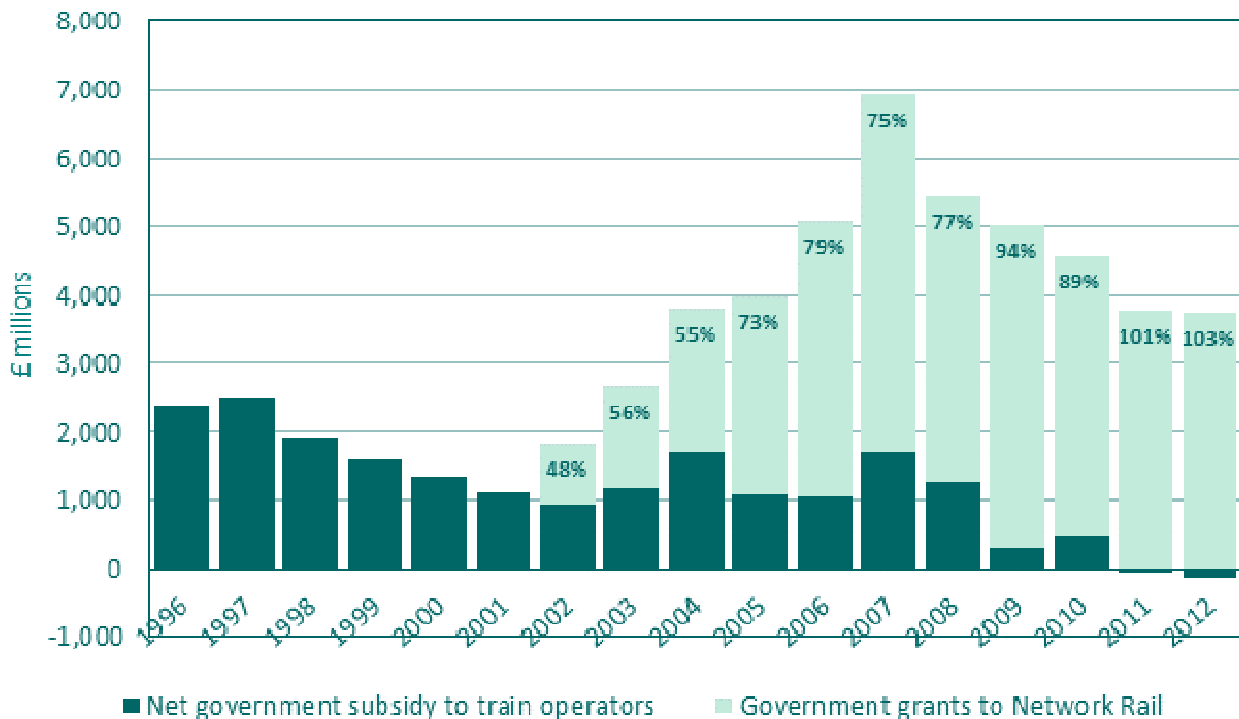
<sup>110</sup> The ORR set this rate to reflect the risks and opportunities that exist in the regulated market for railway infrastructure assets and equates to the cost of capital for this market. (Source: Network Rail annual report and accounts, 2012).

<sup>111</sup> This is the Office of Rail Regulation's calculation of the value of Network Rail's assets. It is a measure that differs from total assets as some assets fall outside the regulator's ambit. This is a measure increasingly used by regulators of former privatised companies. The ORR defines its purpose as a (a) means for determining charges –

is, in effect, the amount that Network Rail is allowed to charge TOCs for use of its rail assets and this has been consistently reduced so that lower track access charges become possible and the funding gap is plugged by government from other sources. Second, lower track access charges change political appearances and possibilities of value extraction for private corporates because these charges are the lever which determines where the subsidy goes in and where the profit appears.

In a subsidised, fragmented, private rail system the key political choice in many ways is not how much subsidy but where and how it goes in. More in at one point in the system means less in at another point. This effect can be tracked in the relevant railway accounts and is summarised below. As exhibit 31 shows, public subsidy to Network Rail rose sharply from less than £1bn in 2002 to stabilise at around £4bn to £5bn per year from 2006 onwards. Net public subsidy to the TOCs meanwhile has fluctuated but with an overall downward trend from 2004 onwards.

**Exhibit 31: Government subsidy to TOCs and Network Rail<sup>112, 113</sup> (2012 prices)**



This matters in two ways. First, in terms of appearance, the government and ATOC can make the claim, at least since 2011, that overall the TOCs are a net contributor to the public finances given that during the past two years TOC franchise premium payments have exceeded their (direct) subsidies in the form of franchise subsidies and grant income. And of course, TOCs need profits because profits are what they can legitimately distribute as dividends to corporate parents. Furthermore, without the prospect of profitability, no company would bid for the franchises and

and spreading impact on customers over time; (b) basis for remunerating investors – rate of return and depreciation/amortization; (c) setting Incentives; (d) as a transparent measure of investments and assets (Source: <http://www.internationaltransportforum.org/Proceedings/InfrastructureInv/McMahon.pdf>)

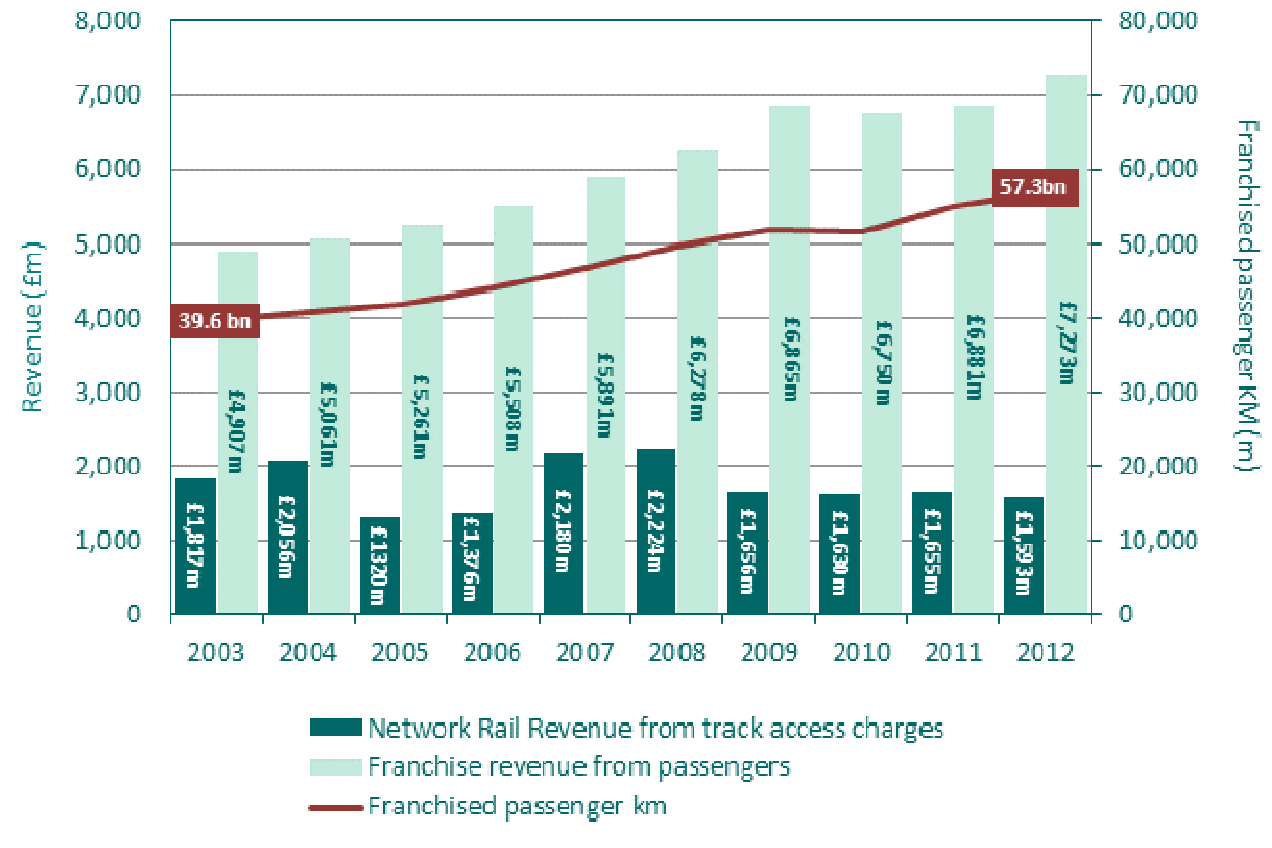
<sup>112</sup> Government subsidy to train operating companies includes grants, franchise payments and performance receipts.

<sup>113</sup> Source: ORR.

the DfT would be forced to admit system failure. So, in this world of politically constructed profit, for TOCs and government, if it looks good, it is good.

This has nothing to do with any kind of economic or accounting rationality. As we have argued in the first section of this chapter, the infrastructure funding regime was changed because it was politically expedient to do so with the arrival of Network Rail (not because Railtrack had been unreasonably overcharging). And, as we can see from exhibit 30, the track access charges which raised nearly £3 billion a year for Railtrack now bring in an income of just over £1.5 billion. In principle, lower track access charges would be justified if the TOCs were running fewer trains in recent years or if the tracks were in a state of decay and declining utility. However, the opposite is true. As exhibit 32 shows, the track access charges paid by the TOCs have fallen *despite passenger kilometres travelled and hence TOC revenues rising consistently*. It is therefore appropriate to consider the outcome of deliberately lowered track access charges as an *indirect subsidy*, which is in addition to the direct subsidies given to the TOCs. A new Control Period began in 2009 and this explains some of the reduction in track access charge under a different pricing scheme in the 2009-2012 period shown in exhibit 32. There are also some changes in the franchise operators in this later period.

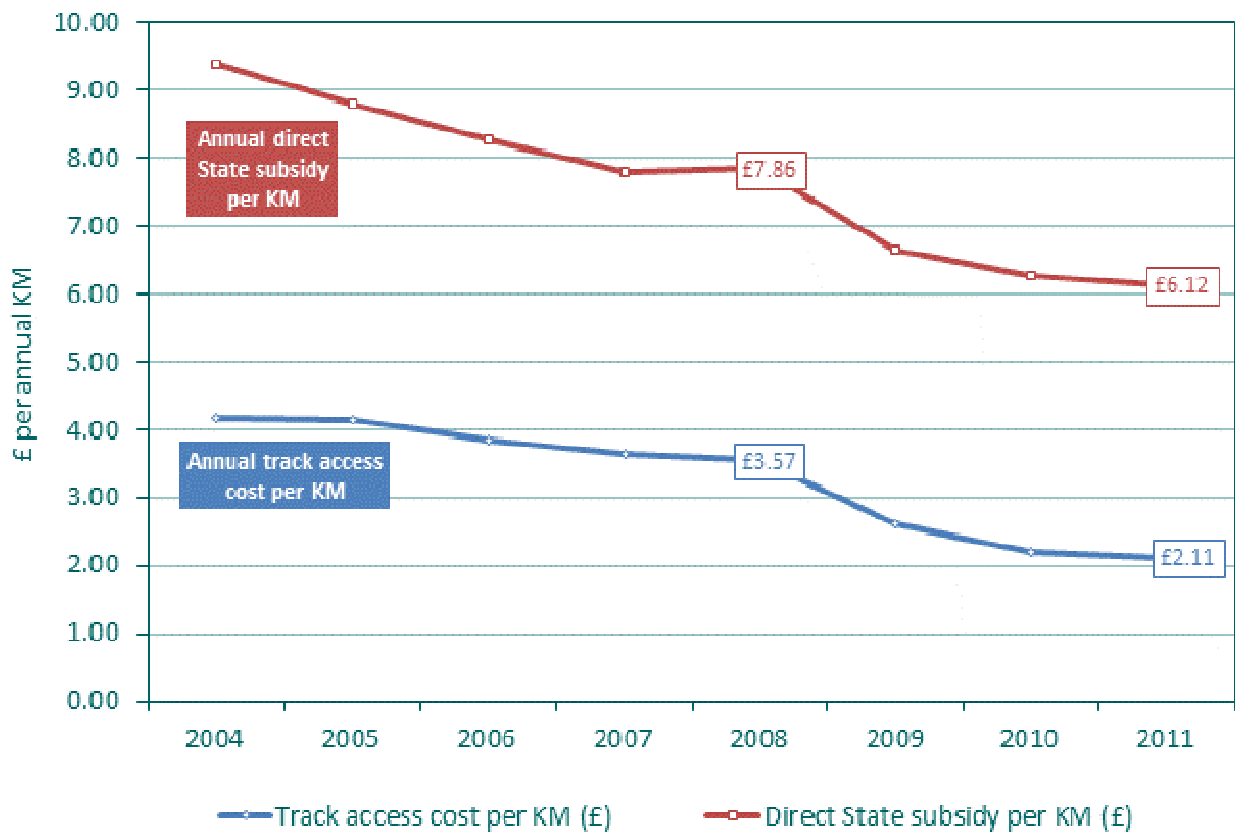
**Exhibit 32:** Comparison of Network Rail Revenue, Franchised TOC revenue from passengers and franchise TOC passenger km travelled (All financial data in 2012 prices)<sup>114</sup>



<sup>114</sup> Source: Regulatory accounts and ORR National Rail Trends.

The implication is that the TOCs are now being grossly undercharged for track access and thereby benefit massively from an undisclosed and indirect public subsidy of several billion each year. The published accounts of individual TOCs do not disclose indirect subsidy and therefore can give a completely misleading impression of being a going concern. Two examples are considered to show the significance of the reduced track access charges: we consider, first, Arriva Trains Wales and, second, London Midland. The published accounts of both companies create the impression that each franchise is making progress towards standing on its own feet. The position of both these franchises is better represented as that of a dependent state client. And this is summarised in the exhibits 33 and 34 which show that in both franchises, as direct public subsidy declines so does track access charges, so that explicit direct subsidy is being replaced by an undisclosed indirect subsidy. And this effect is powerful because, in extreme cases like London Midland, the amounts paid in state subsidy and track access charges are roughly equal.

**Exhibit 33:** Arriva Trains Wales annual per KM track access charges, direct State subsidy<sup>115</sup> and ratio of track access charges to direct subsidy, 2004-2011<sup>116</sup> (2012 prices)



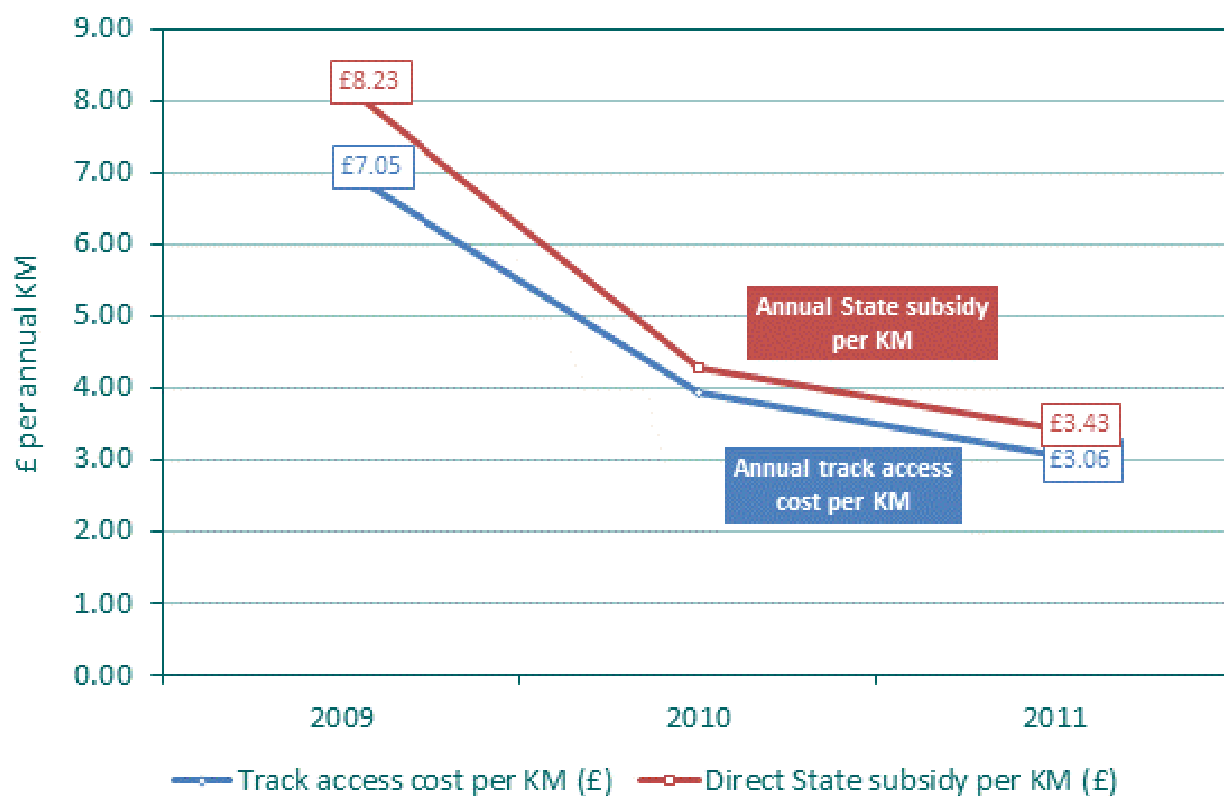
Arriva Trains Wales is illustrated in Exhibit 33. The direct state subsidy declines from just over £9 per km per year in 2004 to £6.12, which on the face of it suggests that state support has fallen significantly. However, over the same period the annual track access charge falls by about a half to £2.11 per km in 2011. In effect this indirect subsidy covers much of the headline decline in direct

<sup>115</sup> Subsidies include revenue grants, performance payments and other compensation. After the formation of Network Rail, subsidies related to track access were paid directly to the company. Under Railtrack's tenure, state subsidy for track access charges were paid via the TOCs. Franchise payments relate to the premium paid by the franchisee to the state.

<sup>116</sup> Arriva Trains Wales annual report and accounts, various years and Office of Rail Regulation.

support. A similar pattern is shown over two years for London Midland in Exhibit 34. The loss of direct subsidy of £4.80 per km is substantially compensated for by an increase in indirect support as track access charges are reduced by £3.99 per km.

**Exhibit 34:** London Midland<sup>117</sup> annual per KM track access charges, direct state subsidy<sup>118</sup> and ratio of track access charges to subsidy, 2009-2011<sup>119</sup> (2012 prices)



On track access charges, the TOCs are in the position of lucky tenants of a philanthropic landlord who (as we shall see in the next section) makes large investments to improve your flat and then lowers the rent so you can keep more of your income.

This assertion sounds outlandish but is in fact fully confirmed by recent figures released by the DfT<sup>120</sup> and shown in Exhibit 35. If we begin by excluding the Network Grant, 8 of 18 franchises receive a net direct subsidy because franchise subsidies exceed franchise payments (and this number could still grow as younger franchises become eligible for cap and collar revenue support)<sup>121</sup>. However, this Network Grant aid can be included in 16 franchises for which the DfT lists the value of the Network Grant in pence per mile<sup>122</sup>, and then 15 of these 16 franchises are net recipients of direct government subsidy. The total direct subsidies then vary quite considerably,

<sup>117</sup> London Midland is the trading name of London & Birmingham Railways.

<sup>118</sup> See footnote 115 and 124.

<sup>119</sup> Sources: London & Birmingham Railways annual report and accounts, various year and Office of Rail Regulation.

<sup>120</sup> Cost of running the rail network, DfT. <https://www.gov.uk/government/publications/cost-of-running-the-rail-network>

<sup>121</sup> There is a system of 'revenue support' whereby TOCs can receive an increase in subsidy or a reduction in premium payments if their revenue undershoots their revenue projections. (Source: <http://railwayeye.blogspot.co.uk/2012/10/cap-and-collar-costs-revealed.html>)

<sup>122</sup> Arriva Trains Wales and First Scotrail fall under the jurisdiction of the Scottish and Welsh devolved governments.

from less than one pence per mile to more than 20 pence per mile in the case of First TransPennine Express and Northern Rail.

**Exhibit 35:** Government direct and indirect subsidy for current UK rail franchises 2011/12<sup>123</sup>

	Net franchise payments	Net revenue support	Total direct government subsidy to TOCs	Indirect government subsidy via Network Rail grants	Total direct and indirect government subsidy <sup>124</sup>
	Pence per mile	Pence per mile	Pence per mile	Pence per mile	Pence per mile
Arriva Trains Wales	n/a	n/a	19.0	n/a	n/a
C2C	-2.0	0.0	-2.0	7.0	5.0
Chiltern Railways	1.0	0.0	1.0	12.4	13.5
CrossCountry	-0.6	0.9	0.3	14.7	15.0
East Coast <sup>125</sup>	-6.2	0.0	-6.2	6.6	0.5
East Midlands Trains	-4.8	1.9	-3.0	13.7	10.8
First Capital Connect	-9.1	1.5	-7.6	5.4	-2.2
First Great Western	-8.8	5.8	-3.0	8.8	5.8
First Scotrail	n/a	n/a	18.0	n/a	n/a
First TransPennine Express	8.0	0.0	8.0	12.1	20.1
Greater Anglia	-4.2	0.0	-4.2	8.1	3.9
London Midland	5.0	0.0	5.0	10.7	15.8
National Express East Anglia <sup>126</sup>	-5.3	1.8	-3.5	8.6	5.1
Northern Rail	8.2	-0.9	7.3	27.6	34.9
Southeastern	1.5	1.9	3.4	9.7	13.0
Southern	-0.6	0.0	-0.6	7.0	6.4
South West Trains	-8.8	2.4	-6.4	7.4	0.9
Virgin Trains	-5.7	1.2	-4.5	8.1	3.6

This result is all the more remarkable because the TOCs pay rent in the form of track access charges but do not contribute significantly to infrastructure investment in any other way. As exhibit 36 shows, private investment in the railways has been minimal and in recent years much more money has been stripped out by the TOCs from the system in dividends.<sup>127</sup>

<sup>123</sup> Source: DfT /ORR.

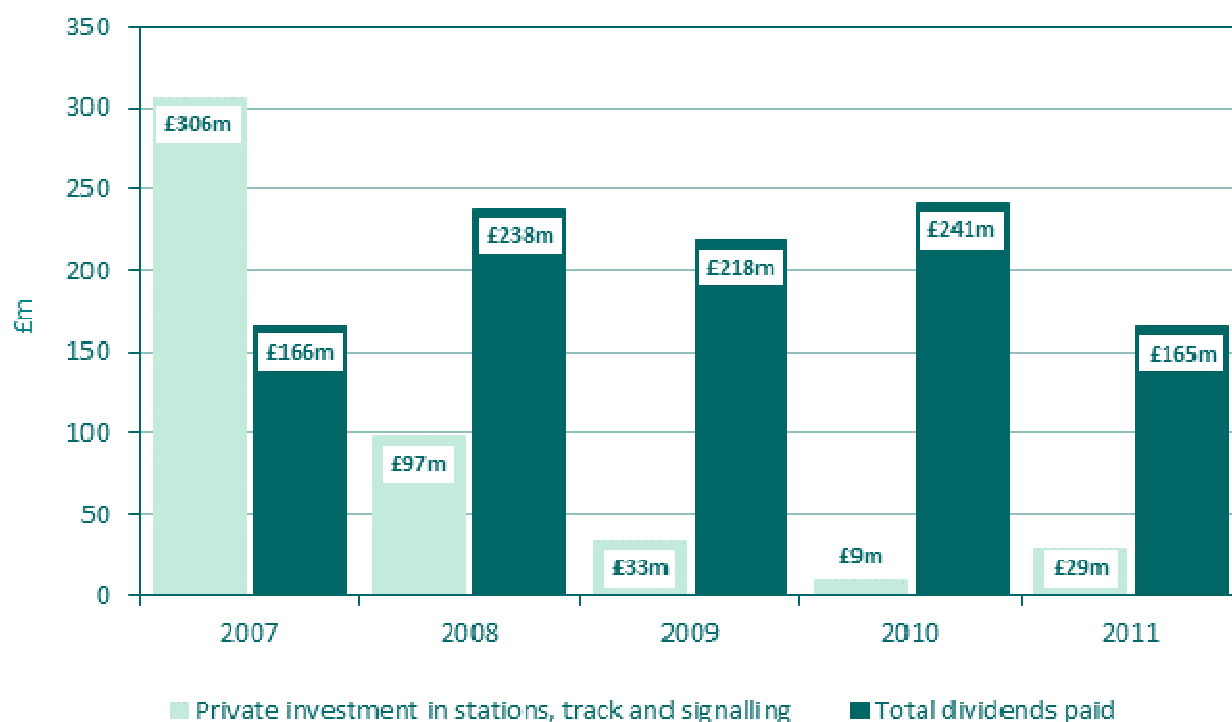
<sup>124</sup> Notes: 'Direct subsidy' relates to payments made directly to the TOCS, calculated from the company annual report and accounts and ORR data. 'Indirect subsidy' includes the effects related to Network Rail's lowering of the track access charges that TOCs pay to Network Rail, as discussed in the text.

<sup>125</sup> Operated by Directly Operated Railways, a company which is wholly state owned.

<sup>126</sup> National Express East Anglia appears here despite no longer existing as a franchise because it was still active in the year to which this exhibit relates.

<sup>127</sup> This total is based on ORR surveys of companies other than Network Rail –it will include TOCs –to supply investment information under the following categories (a) track and signalling including new routes and new

**Exhibit 36: Private investment<sup>128</sup> in stations, track and signalling<sup>129</sup> vs. TOC dividends, 2007-2011<sup>130</sup>**  
(£m, 2012 prices)



The lowering of track access charges does matter because it has created the habitat for value extraction and legitimated the TOCs whose visible subsidy seemed to decline sharply. It could be represented a secondary issue for the taxpayer who would one way or another have to find a large subsidy for railways. But that is not the end of the matter because investment is being funded on another line of a different set of corporate accounts as Network Rail issues private debt for which the tax payer is liable.

### Accumulating Debt

The problem of accessing the capital markets to obtain funds for investment was unresolved when Railtrack went under. The Labour Government addressed the problem by allowing Network Rail to issue private debt with repayment publicly guaranteed so that Network Rail effectively borrowed the government's credit rating and large funds for investment could be raised by selling bonds without paying penal rates of interest. As we will argue below, this fix worked to create an investment fund by storing up problems both for Network Rail, which had to service the debt and for the taxpayer who was liable in the event of default.

electrification; (b) rolling stock including eligible refurbishment work; (c) stations including retail outlet buildings; (d) all other expenditure associated with the rail business, such as non-rail vehicles and business related costs such as IT and web related costs. (Source ORR, <http://dataportal.orr.gov.uk/displayreport/report/html/5cc4eb14-fe68-4b72-aebf-81625df90d86>)

<sup>128</sup> See footnote 121.

<sup>129</sup> Network Rail is responsible for the vast majority of spend on track and signaling. The spend by TOCs is mainly on stations where they have direct responsibility.

<sup>130</sup> Company annual report and accounts.

The background is of course political. In the early 2000s, Chancellor Gordon Brown was concerned not to limit public borrowing but to massage the public debt figures by holding debt off balance sheet. As long as Network Rail was formally a private company, its debt would not appear on the public books although, as explained in Network Rail's latest regulatory accounts, all of Network Rail's debt is guaranteed by the government.

**Exhibit 37:** A comparison of Railtrack and Network Rail's capital structure 1994-2012<sup>131</sup> (2012 prices)

	Shareholder equity	Long-term debt <sup>132</sup>	Shareholder equity as a % of equity and L-T debt	L-T debt as a % of equity and L-T debt
	£mill.	£mill.	%	%
1994-95	2,408	2,468	49.4	50.6
1995-96	3,948	5	99.9	0.1
1996-97	4,111	427	90.6	9.4
1997-98	4,160	1,101	79.1	20.9
1998-99	4,723	1,798	72.4	27.6
1999-00	5,014	2,670	65.2	34.8
2000-01	3,712	3,045	54.9	45.1
2001-02	1,268	0	100.0	0.0
2002-03	780	1,929	28.8	71.2
2003-04	3,215	10,188	24.0	76.0
2004-05	5,232	8,967	36.8	63.2
2005-06	4,613	17,432	20.9	79.1
2006-07	5,942	18,491	24.3	75.7
2007-08	7,404	17,255	30.0	70.0
2008-09	7,522	24,082	23.8	76.2
2009-10	6,455	25,395	20.3	79.7
2010-11	7,314	24,103	23.3	76.7
2011-12	7,917	27,929	22.1	77.9
Railtrack 1994-2001			70.7	29.3
Network Rail 2002-2012			24.5	75.5

*Ultimately, the Group benefits from a financial indemnity mechanism [expiring 2052] provided by the Secretary of State for Transport. This means that in the event of non-payment of financial cash flows by Network Rail, the United Kingdom Government would meet these*

<sup>131</sup> Railtrack and Network Rail annual report and accounts, various years.

<sup>132</sup> Debt refers to 'amounts repayable after more than one year' which under accounting rules is classified as long-term debt (and excludes the portion of former long-term debt due for repayment within 12 months). The L-T debt category summates bank loans and bonds. Source: Network Rail annual report and accounts.

obligations unconditionally. The chance of that indemnity being called upon should remain remote given the stable capital structure and regulatory regime in which Network Rail operates. In view of the indemnity, the credit rating given to Network Rail's debt is based on that of the United Kingdom Government. The ratings from the three principal rating agencies are AAA Negative (Fitch), Aaa Negative (Moody's) and AAA (Standard and Poor's).<sup>133</sup>

With this credit rating established, a subsidiary company called Network Rail Infrastructure Finance began issuing large amounts of long term debt to pay for badly needed maintenance and renewal work to cover the legacy of underinvestment before privatisation and under Railtrack (as well as on-going problems about out of control costs and value extraction).

The result in terms of capital structure was a massive shift towards debt financing of the infrastructure company as Network Rail accumulated a huge mountain of debt. As exhibit 37 shows, Railtrack had never been less than 50% equity financed because it could not and did not issue large amounts of investment grade paper. By way of contrast, Network Rail has been nearly 80% debt financed in recent years because it has within a decade increased its debt to some £30 billion and, as exhibit 38 shows, more than £25 billion of that increase was new long term debt, mainly in the form of newly issued bonds. As this is, by any standard, a big number, the first thing that needs to be said is that it is not clear exactly what the £30 billion of debt has bought by way of assets.

**Exhibit 38:** Network Rail's debt against growth in the Regulatory asset base<sup>134</sup> (2012 prices)



<sup>133</sup> Network Rail (2012), *Regulatory Financial Statements*. Year ended 31 March 2012. Available at <http://www.networkrail.co.uk/browse%20documents/regulatory%20documents/regulatory%20compliance%20and%20reporting/regulatory%20accounts/regulatory%20financial%20statements%20for%20the%20year%20ended%2031%20march%202012.pdf>, p. 14.

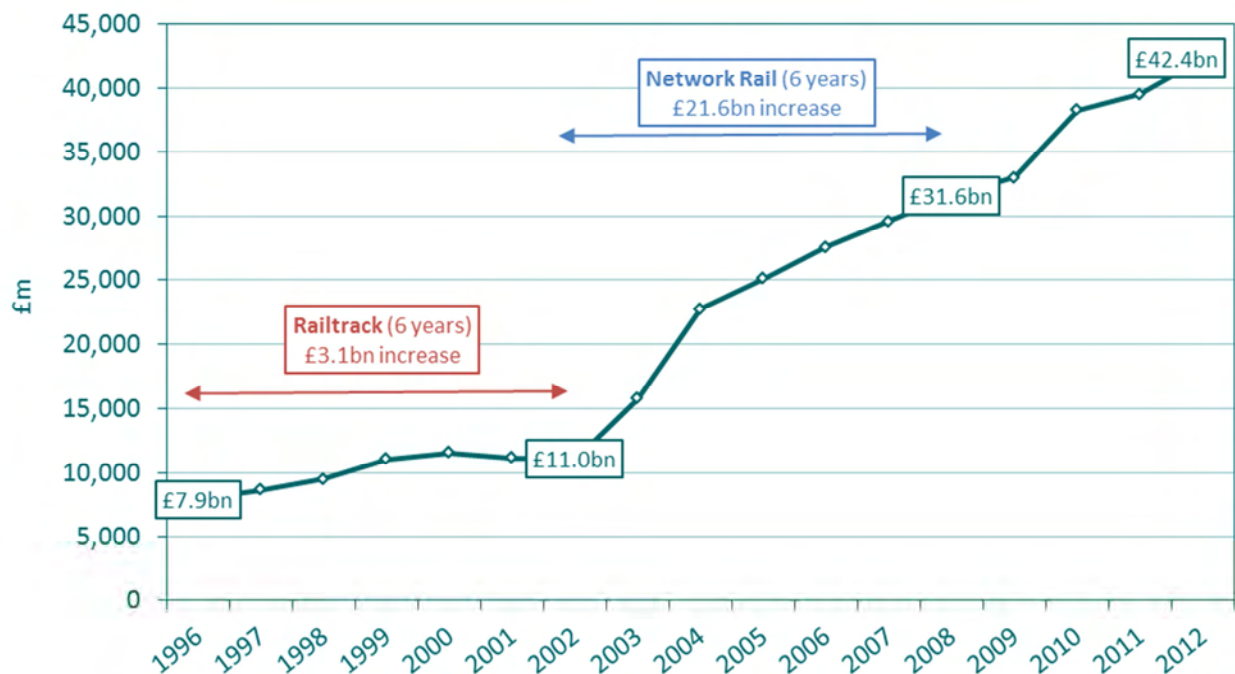
<sup>134</sup> Network Rail Regulatory Accounts, various years.

If we turn to the accounts, we find that the so-called ‘Regulatory Asset Base’ (RAB) – the ORR’s calculation of the value of Network Rail’s/ Railtrack’s infrastructure assets – increased steeply in line with the expansion in long-term debt on Network Rail’s balance sheet.

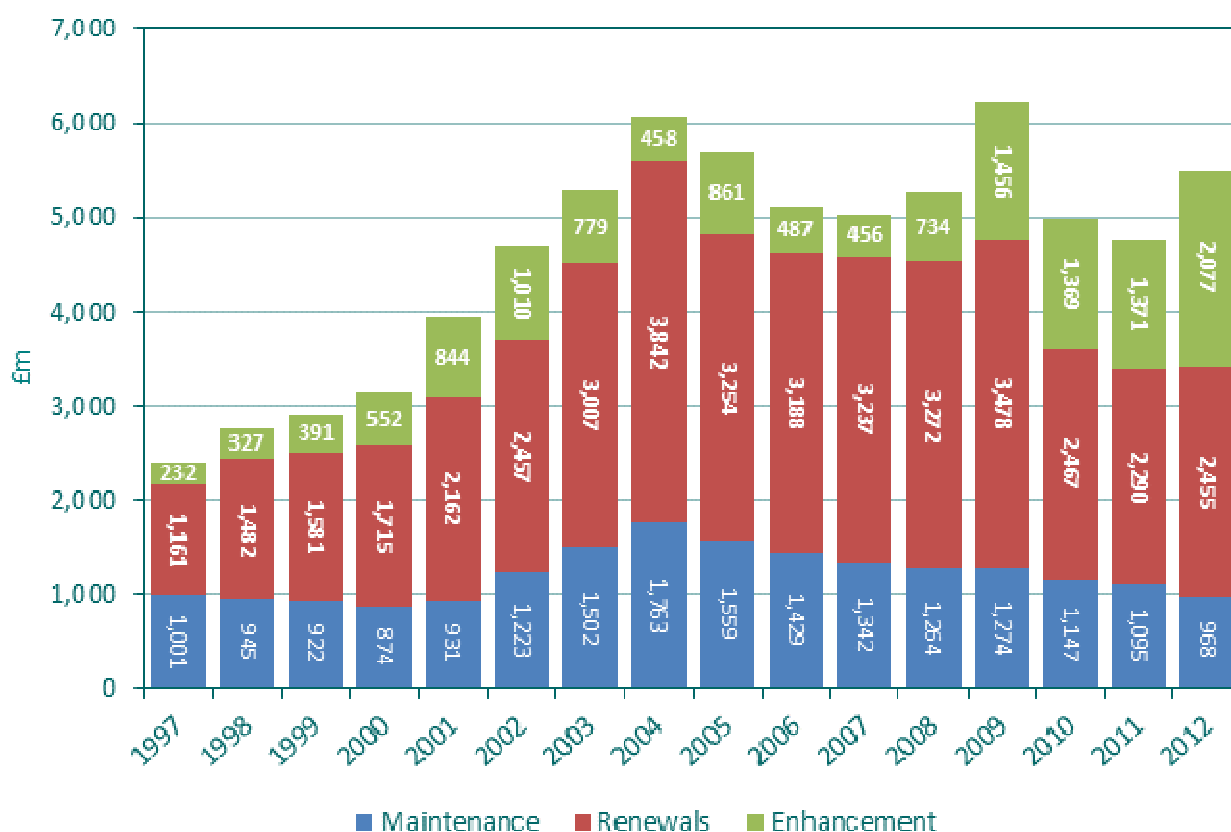
And exhibit 39 shows that this broke with the trend of modest increases in the Railtrack era. The regulatory asset base grew slowly from around £8.5bn in 1996 at the point of Railtrack’s IPO to £11.5bn in 2002 when Network Rail took over. After increasing by just over a third during Railtrack’s tenure, the RAB then grew by over 100% to £23.4bn in just two years as Network Rail spent heavily. The 2012 accounts value the RAB at £42.4bn. It may be reassuring in accounting terms to find, as we do, that the growth in debt liabilities is matched by a nearly equal and opposite increase in infrastructural assets. But that is book keeping and the fact remains that £30 billion of debt has bought a disappointingly small amount of new facilities or dramatic upgrading of the rail infrastructure. There are two major reasons; first, poor major project control and second the pressing and prior claims of renewals and maintenance work.

Maintenance work was brought in-house following Hatfield, but work on renewals and enhancements is still largely outsourced and consequently still troubled by poor project control with costs inflated by multiple private sector profit margins and issues about managing private contractors. The McNulty *Rail Value for Money Study* estimates that Network Rail is 30-40% less efficient than comparable rail infrastructure companies in the EU and major projects like the West Coast Main Line upgrade have run over time and over-budget.

**Exhibit 39:** Growth in the regulatory asset base since privatization<sup>135</sup> (2012 prices)



<sup>135</sup> Railtrack and Network Rail Regulatory accounts.

**Exhibit 40: Changes in Railtrack / Network Rail infrastructure spending since privatization<sup>136</sup> (2012 prices)**

In addition perhaps, new capital expenditure is being crowded out by the claims of renewals on limited funds. Most of Network Rail's spending is on routine renewals and maintenance; only 18% of total infrastructure spending since privatisation has been on 'enhancements'. As exhibit 40<sup>137</sup> shows, spending on enhancements has increased significantly under Network Rail, particularly in the past four years. The question now is whether, under pressure to meet regulator demands for a 21% improvement in efficiency by 2014, Network Rail has been neglecting renewals. The reduction in renewals spending since 2009 visible in exhibit 40 is, according to the ORR, due 'in part to having deferred activity', who say that while 'sustainable reductions in renewal volumes which do not jeopardise the safe delivery of required outputs are a legitimate and important source of efficiency ('scope efficiency') ... deferral is not counted as efficiency.'<sup>138</sup>

If there are many unresolved questions about what Network Rail's £30 billion of debt was spent on, it is clear that the legacy of this debt burden is accumulating problems for Network Rail, the creation of a new class of claimant and awkward liabilities for the tax payer.

<sup>136</sup> Source: Railtrack and Network Rail annual report and accounts, and regulatory accounts, various years.

<sup>137</sup> Maintenance refers to the upkeep of the network and is regulated by the Section 82(5) of the Railways Act 1993 which defines 'maintenance' as including the detection and rectification of any faults. Renewals refers to major capital works or replacement of the network in order to maintain its required capability. These may be required at specific times but are more often carried out according to Network Rail's own timetable. Enhancement refer to changes to network outputs, usually involving construction, that improves network capacity or capability (e.g. enabling higher speeds, allowing heavier loads) relative to the level of network outputs funded at the last relevant periodic review. Usually outputs are required at specific times (in contrast to most renewals). Source: ORR.

<sup>138</sup> [http://www.rail-reg.gov.uk/upload/pdf/nr\\_annual\\_asesment\\_2010-11.pdf](http://www.rail-reg.gov.uk/upload/pdf/nr_annual_asesment_2010-11.pdf)

To begin with Network Rail may be protected by government guarantee but it certainly has a wrecked balance sheet in the sense that it does not realistically have any source of rail sector income from which it could repay its £30 billion of debts. It also finds it increasingly difficult to service that debt and at the same time to finance network renewal and enhancement. This is all nicely ironic if we connect these balance sheet problems with the operating decisions analysed in the last section. If Network Rail had not lowered track access charges and charged Railtrack levels of access rates on increasing passenger numbers, then track access charges would have raised another £15 billion and (other things being equal) half the publicly guaranteed debt would not have been incurred. The immediate practical issue for Network Rail is the burden of interest payments which are increased by the fix of private debt with public guarantees that suited the Treasury better than Network Rail. Interest payments on Network Rail's private debt (with public guarantees) are larger than they would be if the Treasury had directly issued the debt and passed the proceeds to Network Rail. The consultancy Just Economics in a study for the RMT estimates the additional cost to be upwards of £150m a year, which goes to private bondholders;<sup>139</sup> by way of contrast at the peak of its extraction, Railtrack was distributing no more than £130m a year in dividends. In effect, Network Rail has acquired a new stakeholder whose financial claims are prior to those of investment. As shown in exhibit 41, in 2003-4 Network Rail's spending on track maintenance was roughly four times larger than interest paid; but debt has since increased so that Network Rail is now spending significantly more on servicing its debt than on maintaining the track. The company's latest regulatory accounts show that of the £5bn in new debt issued over the most recent financial year, half of it was for the purpose of servicing its existing debt.

**Exhibit 41:** Network Rail's spending on infrastructure maintenance compared to net interest paid<sup>140</sup> (£m, 2012 prices)



<sup>139</sup> Taylor, I and Slomann, L (2012), *Rebuilding Rail*. Available at

[http://www.transportforqualityoflife.com/u/files/120630\\_Rebuilding\\_Rail\\_Final\\_Report\\_print\\_version.pdf](http://www.transportforqualityoflife.com/u/files/120630_Rebuilding_Rail_Final_Report_print_version.pdf)

<sup>140</sup> Network Rail regulatory accounts, various years.

This accumulating mess is the major contradiction arising from the last non-resolution in 2001-2. The debt mountain is the taxpayer's liability and the basic choices are uncongenial. On the one hand, the tax payer could accept that Network Rail's capacity to maintain and enhance the rail infrastructure is increasingly limited by debt servicing charges; or, on the other hand, the debt could be 'written off' in a way that is not painless because the Treasury must then recognise the loss as increased public expenditure or debt. In the interim, the government will likely just put in more subsidy to keep things going and prevent a crisis.

## Appendix A: 'Accounting reasons' and track access charges

The question is: how and why were track access charges not raised in 2003 to cover the projected increase of capital expenditure after the collapse of Railtrack? Or, more precisely, when the opportunity arose, how and why was a proposed increase cancelled late in the day? The short answer is political intervention led by the Treasury which had its own public sector borrowing requirement motives for preferring no increase in charges, and thereby (partly by happenstance) made the TOCs look more self-reliant, boosted TOC profits and wrecked Network Rail's balance sheet.

The key decisions here were only elliptically explained in a 2003 House of Commons statement by the then transport secretary. The decision making story is complex and has been obfuscated by Network Rail, the ORR, and the DfT, which do not provide a simple explanation of the rationale for not raising track access charges but bury the explanation in thousands of pages of esoteric, jargon filled documents now in the government archive.

To begin with, some technicalities have to be explained. Track access charges (TACs) are composed of fixed charges and a variety of variable charges (the latter category of charges designed to compensate for the stress of increased traffic) which are set, following determinations of Network Rail's budgetary requirements, at five year control periods. Proposals are made by Network Rail, consultations are carried out with the customers – the TOCs – and final approval is granted by the ORR and the DfT.

We are currently in control period four (CP4), lasting from 2009 to 2014, and reviews are currently underway to ascertain TACs for control period 5 (CP5), from 2014. The tilt towards a heavier reliance on the Network Grant and publicly guaranteed borrowing (as opposed to higher TACs) was the outcome of a process which began with the 2000 Periodic Review of TACs (at which point Railtrack was still in existence) and ended with the subsequent implementation of a new TAC regime from 2003 in the run up to the start of CP3 in 2004. This set the present system in motion, and the premises have remained the same since.

This review of TACs was the first since the collapse of Railtrack. It was agreed that, although efficiency gains could be made by bringing maintenance work in house, such gains could not fund the large increase in capital expenditure which was urgently required. To quote the ORR in their conclusion to the 2003 review:

*In total, the Regulator has concluded that it is appropriate to allow for Network Rail to spend significantly more than he allowed Railtrack in his October 2000 access charges review, because this will enable Network Rail safely and effectively to tackle the legacy it inherited from Railtrack: a legacy of poor planning and project delivery; inadequate arrangements for managing suppliers and subcontractors; inadequate levels of maintenance and renewal activity; poor customer focus; and an insufficient grasp of the causes of and cures for poor day-to-day performance.<sup>141</sup>*

But where was the money for this going to come from? Network Rail and the ORR had, by the end of the consultation process, reached a decision to scale down subsidies from the government (which were at this point in time channelled through the now-deceased Strategic Rail Authority (SRA)) and substantially raise TACs to the TOCs. The original and explicit plans are set out in exhibit 42. TACs were to be increased so that TAC revenue would rise to £4.1 billion as other grants were discontinued, and become the sole source of support for Network Rail.

**Exhibit 42: Abandoned 2003 Network Rail revenue profile<sup>142</sup>**

	Expected track access charges (TAC) revenue	Grants from the Strategic Rail Authority (SRA)	Total Network Rail revenue
	£m	£m	£m
2004/05	3,164	1,279	4,443
2005/06	3,759	652	4,411
2006/07	3,690	552	4,242
2007/08	4,199	0	4,199
2008/09	4,137	0	4,137

The plans were the outcome of 15 months of analysis and consultation but just 10 days before the ORR was due to publish, politics intervened. The ORR then received a letter from the SRA and DfT informing them that ‘for accounting reasons it would be desirable for the SRA in future to increase the amount of money that it pays in grant to Network Rail allowing access charges to be set at a lower level’.<sup>143</sup>

These ‘accounting reasons’ were complex. Under clause 18.1 of the standard franchise agreement, all TOCs could claim funds from the SRA to pay for increases in TACs introduced at new control periods. Since Network Rail’s control periods and the TOC’s franchises are not aligned, this essentially means that *all* rises in TACs would be funded by SRA subsidies to TOCs. The ORR then

<sup>141</sup> ORR (2003) ‘Access charges review 2003: final conclusions’. Available at <http://www.networkrail.co.uk/browse%20documents/regulatory%20documents/access%20charges%20reviews/p%20review%20access%20charge%20reviews/interim%20review%202003/final%20conclusions/orr%20final%20conclusions.pdf>. Para. 1.2

<sup>142</sup> Source: ORR.

<sup>143</sup> ORR (2003) ‘Access charges review’, para. 18.

explained the SRA preferred to pay grant directly to Network Rail rather than indirectly via TOC subsidies and TAC charges:

*the DfT and the SRA explained that allowing the SRA to pay more directly to Network Rail in grant would reduce the pressure on the SRA's overall franchise support budget at a time when the cost to the SRA of subsidies paid to franchise holders had already risen sharply and was likely to cause the SRA to incur expenditure beyond that which has been allocated to it.*<sup>144</sup>

The issue of SRA subsidy for TOCs was a live one because of cyclical risk when the SRA feared that in a downturn TOC demands for subsidy would go well beyond the contractual requirement to meet clause 18.1 obligations.

The other issue was one of accounting technicalities about what does and what does not count as public expenditure. The SRA said it was desirable to 'to ensure that capital expenditure by Network Rail is properly accounted for in Government accounting terms'. Put more directly, the DfT and Treasury were against higher track access charges because they would breach technical rules on government borrowing and the Treasury wanted the funding routed in other ways which did not increase disclosed public expenditure.<sup>145</sup>

The then transport secretary Alistair Darling explained to the House of Commons that the government's fiscal rules prohibited it from borrowing to fund current expenditure, which it would be doing if it put subsidies into the TOCs so that they could pay higher TAC charges. Under existing rules, it was much easier to put money into Network Rail to pay directly for capital expenditure: such annual capital support should not exceed Network Rail's capital investment (its renewals and enhancements), while its income from sales (TACs) needed to cover only 50% of its production costs (operations and maintenance, plus depreciation).<sup>146</sup> Thus capital grants to Network Rail would be 'appropriate' and within the rules. They would also, and crucially, not be recorded as part of the government's current expenditure by the ONS.<sup>147</sup>

<sup>144</sup> ORR (2003) 'Access charges review', para. 18.

<sup>145</sup> As the ORR explains, 'The accounting rules that governments throughout the European Union must adhere to, do not allow grants to the private sector to be accounted for as capital formation, unless paid directly to the private sector entity undertaking the capital formation. Therefore, such grants cannot be routed through the TOCs.' Periodic review 2008: Determination of Network Rail's outputs and funding for 2009-14, loc. 20.4.

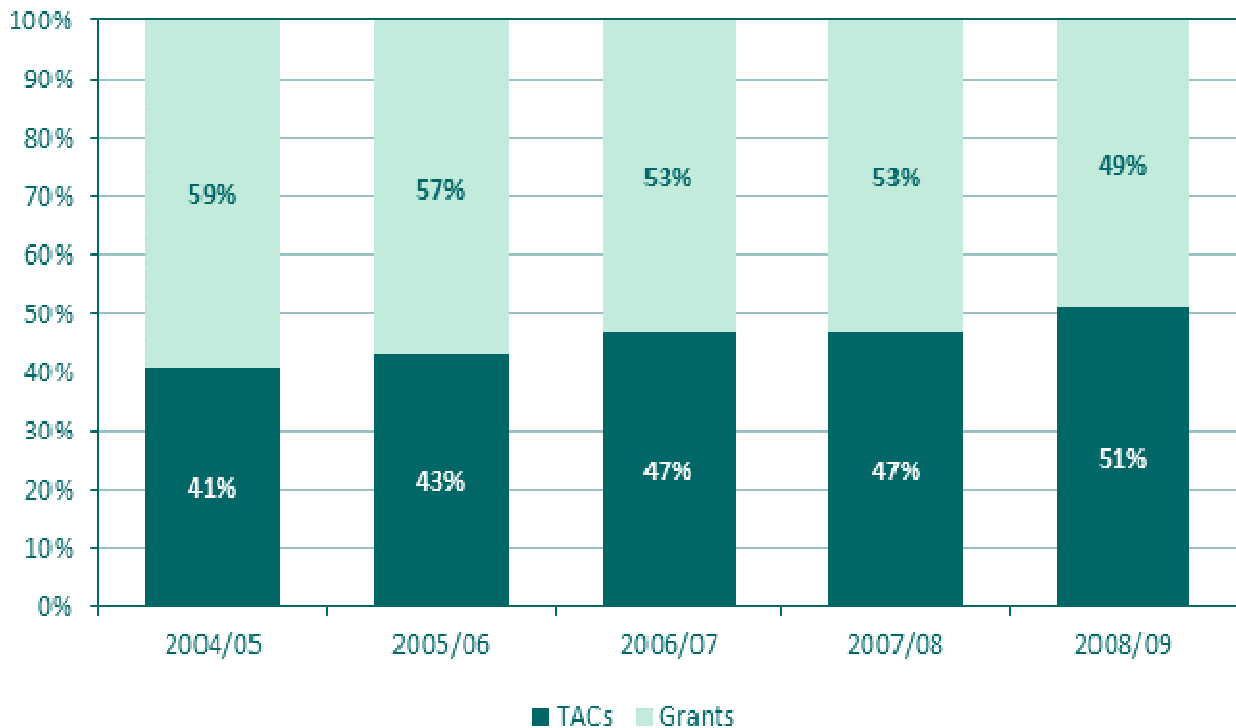
<sup>146</sup> ORR (2003) 'Access charges review 2003: regulator's approval of Network Rail's proposed financing arrangements', para. 2.4.

<sup>147</sup> House of Commons, Official Report, 15 December 2003, Columns 122-124 WS, Rail Regulator's Interim Review, The Secretary of State for Transport (Alistair Darling).

**Exhibit 43:** Network Rail net revenue split (%) proposed and abandoned on insistence of SRA / DfT<sup>148</sup>



**Exhibit 44:** Network Rail net revenue split eventually adopted following SRA / DfT intervention<sup>149</sup>



With some understatement, the ORR concluded it was ‘regrettable that such fundamental issues should be raised at such a late stage in the review’. Nonetheless, a new revenue profile for Network Rail was developed in haste. Under the new arrangements, 54% of Network Rail’s total funding for

<sup>148</sup> Source: ORR

<sup>149</sup> Source: ORR.

the period would come from direct government grants and just 46% from TACs. Under the original proposals, only 11% was supposed to come from grants and 89% would come from TACs. Put simply, the initially proposed TACs were halved after political intervention. The key issue here is not simply the way that this was done but that the fact that the deliberately reduced TACs were then disconnected from subsequent discussion about performance of the TOCs in an act of political forgetfulness.

Meanwhile, to allow Network Rail to ‘reduce the pressure on the SRA’s budget in the short term’, additional borrowing as a ‘transitional measure’ would provide immediate funding in the first two years.<sup>150</sup> This of course proved in the end to be not so transitional.

The final irony was that the government became Network Rail’s paymaster but got no controlling interest. Network Rail was initially suspicious about the implications of the changes in its revenue profile. The organisation was supposed to be accountable to the TOCs and was a private company free from government interference – would not the switch to reliance on government grants undermine its independence? Not so, apparently, as there would be ‘no conditions attached to the payment of the grants because any such conditions could dilute Network Rail’s focus on its contractual obligations to its customers’.<sup>151</sup> Despite the government’s new role, Network Rail was supposed to serve the interests of the TOCs first and foremost.

The system has remained in place since, with the bulk of renewals and enhancements funded by the Network Grant and bonds issued to the capital market – post-2006 with the government’s financial indemnity mechanism in place – and fixed track access charges recovering Network Rail’s residual revenue requirement – the net revenue requirement when all other items are taken into account.

Variable usage charges, which cover adjustments to maintenance budgets as a result of greater traffic on the lines, were lowered at the request of the ORR in time for CP4, with the regulator asking that they be targeted at an ‘efficient’ level, *in advance of Network Rail achieving these efficiencies*. The hope was that ‘on this basis [Network Rail would] avoid pricing traffic off the network that can afford to pay the efficient cost for access’. Again, the policy is explicitly designed around making the world as easy as possible for the TOCs.<sup>152</sup>

In order for Network Rail to pass the ‘market body’ test in government accounting rules, it has to receive annual income from sales (primarily TACs) which cover a minimum of 50% of operating and maintenance costs and statutory depreciation. This allows, despite the overwhelming importance of government funding in the system, the fiction to be maintained that Network Rail has a ‘primary accountability to its customers’.

<sup>150</sup> ORR (2003) ‘Access charges review’, para. 24.

<sup>151</sup> ORR (2003) ‘Access charges review 2003: regulator’s approval of Network Rail’s proposed financing arrangements’. Available at <http://www.networkrail.co.uk/browse%20documents/regulatory%20documents/access%20charges%20reviews/previous%20access%20charge%20reviews/interim%20review%202003/final%20conclusions/orr%20final%20conclusions.pdf>. Para 1.9.

<sup>152</sup> ORR (2008), ‘Periodic review 2008: Determination of Network Rail’s outputs and funding for 2009-14’, Available at <http://www.railwaysarchive.co.uk/docsummary.php?docID=1723>, loc. 19.17.

The ORR, Network Rail and indeed the McNulty report have all argued that the system would work better if all of Network Rail's revenue came from TACs, 'in order to improve Network Rail's customer focus, and help drive better value for money'.<sup>153</sup> (This is confusing, given that without government support, forcing the TOCs to pay the full costs of Network Rail would send ticket prices through the roof). Work is now well underway on the 2013 periodic review for CP5, and the geographical disaggregation of charges is being considered as a means of 'aligning incentives' between TOCs and Network Rail in line with the post-McNulty focus of fragmenting the rail network in the private interest.<sup>154</sup> But it seems for now the system of hidden subsidy for the TOCs will remain entrenched. To quote the ORR on the CP4 review process,

*Our preferred method of funding Network Rail is for all of its income to come from train operating companies and other customers. However, we must have regard to the financial position of the Secretary of State and Scottish Ministers when we are conducting an access charges review. The governments have told us that it is not possible to make changes to government accounting rules. (our emphasis)<sup>155</sup>*

The underlying assumption is that the *only* way for the TOCs to pay higher access charges would be through increased government subsidy which (unacceptably) increased recorded public expenditure. Thus, the TOCs will most likely continue to appear to be modestly subsidised, when they are in fact grossly flattered by an accounting fix.

## Chapter 5: Franchising, predatory contractualism and bids that game the system

### Charge 3: Franchising is predatory contractualism where bidding which is against the public interest generates a simulacrum of capitalism.

The bidding process encourages corporates to game the system with optimistic projections of passenger numbers and back loaded premium payments. This rewards franchisees with easy profits in the early years and shifts risk onto the state because, when things go wrong, the train operators can walk away to avoid large premium payments.

The contracting state is a disaster in rail and the franchise system is unfixable because: (a) the DfT is in a relation of co-dependence with the corporates; (b) long term revenue streams are inherently unpredictable; and (c) maintaining the appearance of competition and markets requires low barriers to entry, and thus also to exit. The result is an economic simulacrum of capitalism which is politically resistant to reform.

<sup>153</sup> ORR (2013 'Periodic Review: Advice to the Secretary of State for Transport on Network Rail's costs and outputs in CP5', Available at <http://www.rail-reg.gov.uk/pr13/PDF/pr13-advice-to-ministers-ew.pdf>, Loc. 3.11.

<sup>154</sup> ORR (2012), '2013 Periodic Review: Setting the financial and incentive framework for Network Rail in CP5', available at <http://www.rail-reg.gov.uk/upload/pdf/financial-incentive-framework-cp5.pdf>

<sup>155</sup> ORR (2008), 'Periodic review 2008', loc. 20.4.

According to McNulty's two year long *Rail Value for Money Study*, the operating franchise system was flawed in execution but fundamentally sound. This verdict was acted upon in the DfT's subsequent reform of franchise conditions and bid processes which offered longer franchises and promised a rebalancing of risk and reward. After the recent troubles over bids for a new West Coast main line franchise, the TOCs blamed the DfT for miscalculation and procedural failure but continued to defend the franchising system. After the initial award to First Group had been overturned, Tim O'Toole, Chief Executive of FirstGroup PLC said, 'This is an awfully traumatic thing not only to us but to the whole industry... We as a group think the franchise system is in no way broken or needs no major overhaul.'<sup>156</sup>

Having outlined an argument so far about subsidies and the debt burden at Network Rail, this chapter presents a much darker account of the franchise bidding process which is the foundation of a system that we call predatory contractualism that generates a simulacrum of capitalism. The chapter describes how bidders for new train operating franchises have repeatedly gamed the system by making overoptimistic projections of passenger numbers and by back loading premium payments so that they gain the option to take and distribute profits in the early years and can at modest cost hand back the franchise so as to avoid onerous premium payments in the later years of the franchise.

This gaming of the system is well understood and explicitly discussed (as mitigating risk for the corporation) by those stock market analysts who cover the corporate parents of TOCs. But frighteningly the DfT seems completely unable to recognise this means shifting risk onto the taxpayer; or to contemplate abolishing the franchise system which abets value extraction and risk passing. We would argue that the DfT cannot defend the public interest because it has what Keynes would have called a 'theological commitment' to the dysfunctional system of franchising: contracts given to the TOCs must by necessity be over-generous in order to attract the requisite number of highly risk-averse private operators and to generate the appearance of a competitive tendering process and a functioning privatised system. The result is a simulacrum of capitalism.

The contracting state is a debacle in railways because the usual arms-length relation between two contractual parties has been replaced by a relation of co dependence whereby the DfT meets the economic needs of the railway corporates for profit because its political objective is to keep things going which it does by generating the simulacrum. The problems about the award of the West Coast franchise were framed as problems about DfT mistakes in following its own procedures and, fair enough, mistakes were of course made inside the Department; but the real scandal was the DfT's inability to see that First Group's bid included optimistic revenue growth and back loaded premiums of a kind which had previously led to franchisees walking away.

## How franchising 'works'

First, it is necessary to understand some details about how the rail franchising system works in theory. The franchise agreement documents between the DfT and a TOC cover five key issues:

<sup>156</sup> Financial Times, 'FirstGroup dividend pledge under threat' 07/11/2012. Available at <http://www.ft.com/cms/s/0/69ca39e0-28b9-11e2-9591-00144feabdc0.html>

- **What services the TOC will deliver:** which stations are served, and with what frequency.
- **The franchise period:** in the era of Office of Passenger Rail Franchising (OPRAF)<sup>157</sup> franchises could be lengthened in exchange for better services, but this was switched to standardised seven year contracts under the Strategic Rail Authority (SRA), with two to three year extensions, depending on performance. Post McNulty, these are set to become 14+ year periods, with the WCML 2012 tender being the first to be carried out under the new system.
- **Standards and targets for these services:** punctuality and customer satisfaction.
- **The level of premium to be paid:** the TOC keeps all the revenue below a certain pre-specified cut off point and makes these premium payments periodically in pre-specified amounts, calculated on an annual basis. The premiums are proposed by the TOCs and approved by the DfT, which does this by risk-adjusting revenues and costs to what it considers to be achievable.
- **The level of subsidy to be supplied:** not all franchises receive subsidy, but where the government does provide it, the level is negotiated in a similar manner to the premiums.

During the period of the franchise, the delivery of these agreements is monitored and officially reviewed in an on-going game of cat and mouse. This is all very far from the original expectation that privatisation would largely eliminate the government role in management of the railways.

The TOCs complain bitterly that they must operate within a complex and exacting set of state requirements. But the contract system can be – and is – gamed to the benefit of private interests. The contract which might appear to be a straightjacket, is in fact a loosely knitted garment full of loopholes to be exploited by the TOCs’ skilled lawyers and accountants. In particular, the TOCs’ regulatory gaming and gambling takes place around the determination of subsidies and premium payments for franchises.

The franchise bidding process in essence operates like an any ‘highest bidder’ kind of auction: the TOCs compete to provide the most attractive offers to government in terms of who will receive the least subsidy and pay the highest premiums. At least this is so since 2004/05, when New Labour’s SRA made pre-specified premiums part of the bidding process. The TOCs have an incentive to overbid and promise more than they can deliver based on optimistic, projections of future revenue growth. The DfT’s job is then to assess the credibility of the bids and develop mechanisms for sharing risk – bearing in mind of course, that if conditions and inducements are not sufficiently generous, nobody would bid in the first place.

### **The Cap and Collar regime and the East Coast and Greater Western debacles**

One of the problems with this franchise system, acknowledged in the recent Laidlaw report, is that franchisees face largely fixed costs while passenger revenues fluctuate according to exogenous factors, like GDP growth or unemployment levels which cannot be accurately predicted far into the future. Neither the bidder nor the DfT has perfect foresight about the state of the economy in three or seven years’ time so compensation policies have been devised to deal with revenues which run above, or fall below, the franchisees’ forecasts.

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<sup>157</sup> OPRAF was replaced in 2001 by the Strategic Rail Authority (SRA), which was disbanded in 2006.

Currently a 'cap and collar' policy is used to determine subsidy and premiums on franchises awarded between 2004 and 2009. After four years of a new franchise have elapsed, a TOC receives a subsidy if its revenue undershoots projections in order to bring it back in line with the estimates provided in the original bid. If revenue is between 98% and 94% of projections, the DfT pays 50% of the gap between this and the target – below 94% and it pays 80% of the shortfall.<sup>158</sup> The system works in reverse for payments from TOCs to the DfT on excess revenues. Premium payments meanwhile remain as set out in the franchise agreement, meaning that in many cases TOCs are, in effect, paying the DfT in premiums with money provided by the DfT.

As we showed in exhibit 35, cap and collar revenue support is claimed by 8 out of the 18 franchises eligible, with half of the one billion pounds received from franchisees in premium payments, in effect, being returned to the TOCs as subsidy over the year.<sup>159</sup> In most other years direct subsidy has completely outstripped premium payments. This is extraordinarily generous if we remember that the direct subsidy to the TOCs through various forms of revenue support must be considered alongside and in addition to the massive indirect subsidy to the TOCs via Network Rail access charges.

However, cap and collar is the subject of continuing complaint by the TOCs. The contracted level of premium payments must still be made regardless of the revenues, meaning that changing external conditions, like economic downturn, can make a franchise unviable within a short space of time (See NXEC below). And the TOCs are reluctant to incur any substantial operating loss by making fixed payments from depleted revenues. TOC parents are usually large companies with substantial resources: in some cases they are multinationals, with multiple business operations across several different sectors. However, specific franchises are run at arm's length by special purpose vehicles (SPVs) so the parents can refuse to bail out the subsidiary and walk away should exogenous factors turn against them.

To our knowledge the government has only once terminated a franchise. The Government ended the Connex South East franchise in 2003 because of financial mismanagement after the company had covered up a shortfall arising from failure to reach cost reduction targets.<sup>160</sup> In the case of GNER, described below, the franchisee was (more politely) asked to give up the contract. But walking away from the contract by the franchisee is commonplace and a real problem. By 2004, nine out of a total of 25 rail franchises had failed or been switched to a cost plus management contract.<sup>161</sup> When the franchisee walks, this means that the expected profile of premiums (usually higher in the later years of the franchise) are not received. This disrupts the original estimates and patterns of costs and benefits (so that the overall cost to the taxpayer will likely be larger than

<sup>158</sup> Stagecoach Group (2012), 'UK Rail Franchise risk sharing'. Available at <http://www.stagecoach.com/investors/financial-analysis/uk-rail-franchise.aspx>

<sup>159</sup> RMT (2012), 'Almost half of UK rail franchises now receiving taxpayer bail-outs due to Department of Transport failures'. Available at <http://www.rmt.org.uk/Templates/Internal.asp?NodeID=164320>

<sup>160</sup> House of Commons Transport Committee (2004), *The Future of the Railway: Seventh Report of Session 2003–04: Volume I*. Available at <http://www.publications.parliament.uk/pa/cm200304/cmselect/cmtran/145/145.pdf>, and <http://www.publications.parliament.uk/pa/cm200304/cmselect/cmtran/145/145.pdf>, and [House of Commons](http://www.publications.parliament.uk/pa/cm200304/cmselect/cmtran/145/145.pdf)

[Committee of Public Accounts \(2006\) \*The South Eastern Passenger Rail Franchise\*. Available at <http://www.publications.parliament.uk/pa/cm200506/cmselect/cmpublicacc/770/770.pdf>](http://www.publications.parliament.uk/pa/cm200506/cmselect/cmpublicacc/770/770.pdf)

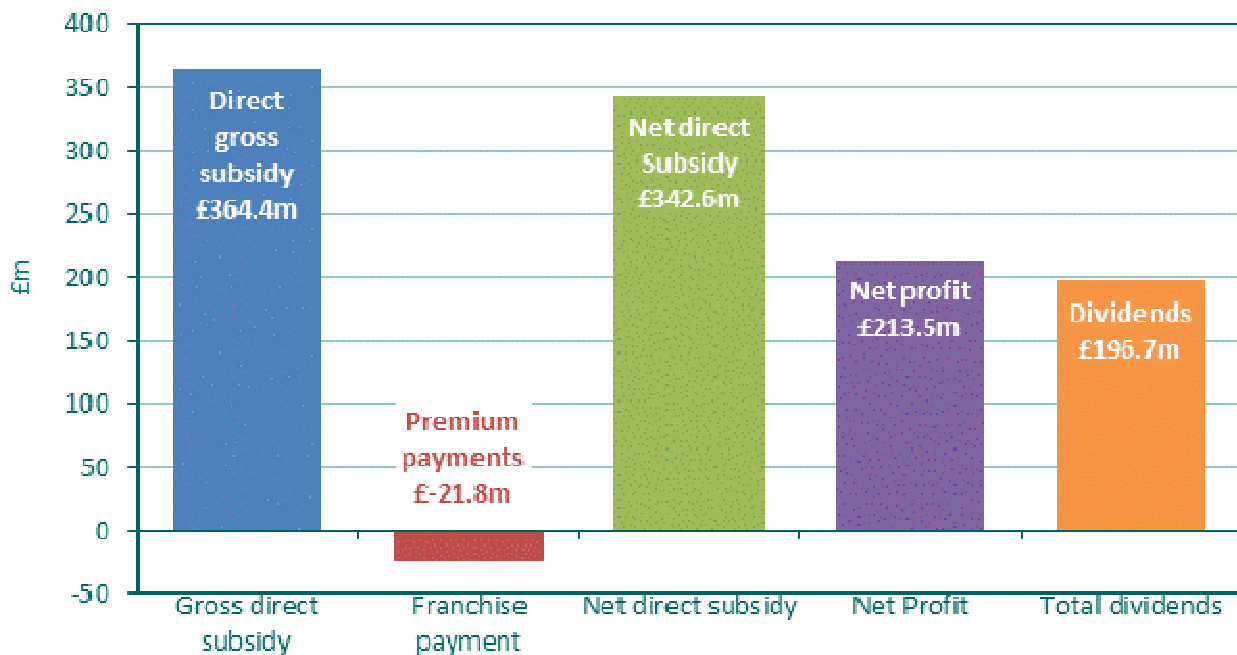
<sup>161</sup> McCartney, S and Stittle, J (2011) 'Carry On up the East Coast': A case study in railway franchising, *Public Money and Management*, 31(2)p. 124.

expected) and shifts the responsibility to ensure that there is continuity in the rail service onto the state which retains the residual responsibility for ensuring passengers can travel.

The DfT has attempted (quite ineffectually) to make sure that TOCs cannot easily walk away from the contract. To this end, the DfT undertakes a financial risk assessment to determine a suitable deposit (in the form of bonds and a subordinated loan) for the parent company and TOC to forfeit in the event that the franchise is abandoned. Nothing better demonstrates the inadequacy of these measures than the serial shambles on the East Coast Main Line.

After privatisation, Great North Eastern Railways (GNER) ran the line from 1997 to 2007, with the incumbent winning a re-franchise competition in 2005. Over the whole period, as exhibit 45 shows, GNER made a very tidy profit from the line having received heavy state subsidy during the opening years of the franchise and a management contract for the final year. And in this context we can understand how and why the DfT's walk away penalties are entirely inadequate. Walking away in 2006 would have been no great disaster for a substantial parent company because the penalty was a modest final offset of less than £40 million penalty against £200 million of profits taken and distributed since 1996. The walk away penalty involved losing £17 million of shareholder equity kept in the company, forfeiting a £15 million performance bond and paying a £2.5 million penalty to cover the cost of re-franchising.<sup>162</sup> But, in the whole period since 1996, the TOC had already distributed £197 million in dividends.

**Exhibit 45:** Great North Eastern Railway: Direct subsidy vs. Extraction, 1996-2007<sup>163</sup> (2012 prices)<sup>164</sup>



In 2006, a crisis was occasioned by financial problems within the TOC parent company, Sea Containers, which was close to insolvency amidst speculation that the TOC (GNER) was not ring

<sup>162</sup> McCartney, S. and Stittle, J. (2011) 'Carry On up the East Coast', p. 125-9.

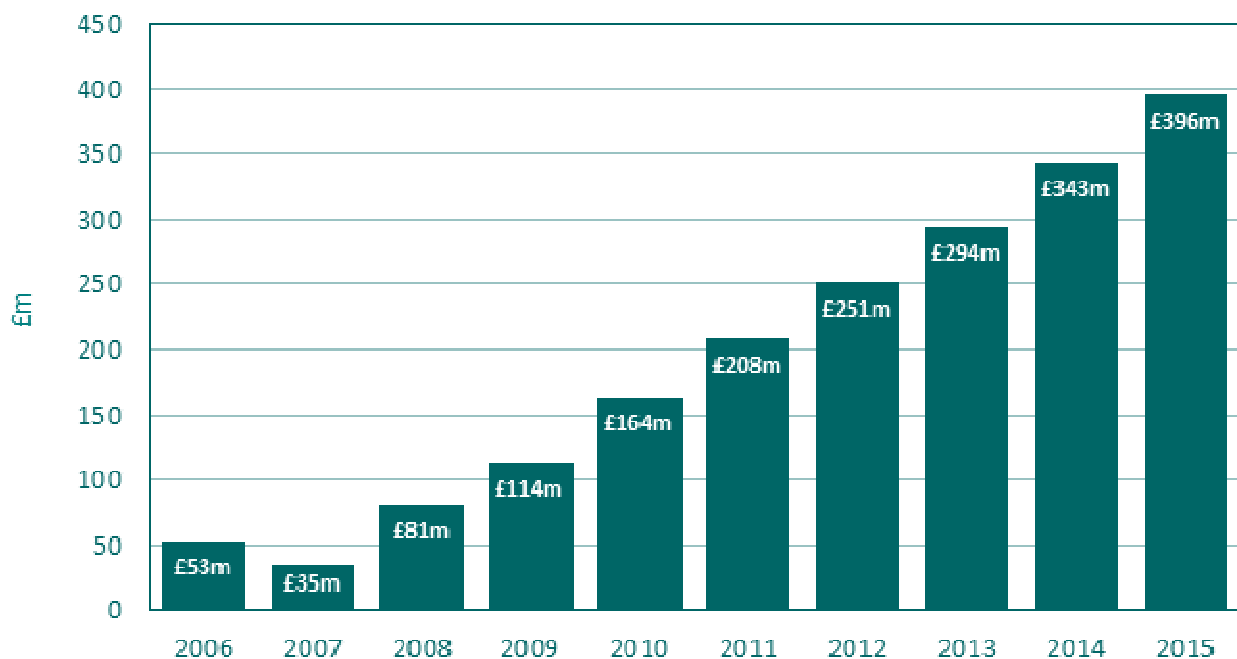
<sup>163</sup> GNER annual report and accounts, various years.

<sup>164</sup> Franchise payments, if made are negative because the TOC makes a contractually obligated payment to the government.

fenced from the parent. Sea Containers fought (unsuccessfully) through the courts during 2006 in an attempt to keep hold of the franchise, with the DfT in December 2006 asking Sea Containers to give up the franchise which it would continue to run under a management contract. There is much that is of interest here, including the initial rumours about recourse from parent to TOC which were nicely ironic given that, vice versa, the parent is always ring fenced from TOC claims. Most interesting is that Sea Containers fought to retain the franchise even though it was struggling to make profits and the departing GNER chief executive said in mid-year that the company, like other TOCs, had bid too high when it won the refranchising competition in 2005.<sup>165</sup>

The answer to any question about parent company motives lies in the bid premium profile, which gave an early option on profit and a later opportunity to walk. As shown in exhibit 46, when winning the bid again in 2005, the GNER company had agreed a steeply rising increment of premium payments to the DfT. The profile of the premium payments suggests either misplaced confidence in the ability of the franchise to generate continual increases in revenue, or a cynical attempt to win the bid by offering the highest total of combined premium payments, while mitigating risk by making sure the bulk of this falls due in the final years of a franchise which will have modest walk away penalties. As exhibit 46 shows, the premium payments were so heavily back-loaded that, even if GNER's revenues had not been dented by the recession, the state was always unlikely to receive the premium payments of the last three years.

**Exhibit 46:** Great North Eastern Railway premium payments promised<sup>166</sup> (Cash)



The lessons of the GNER experience were unclear because this was a one off and *sui generis* franchise crisis where the problems were very unusually with the parent company which could have walked but tried to hang on in. What happened next on the East Coast main line more clearly showed the dangers of walk away with low levels of risk capital injected into the franchise by the parent company and back-loaded premium payments from the TOC. GNER operated the franchise

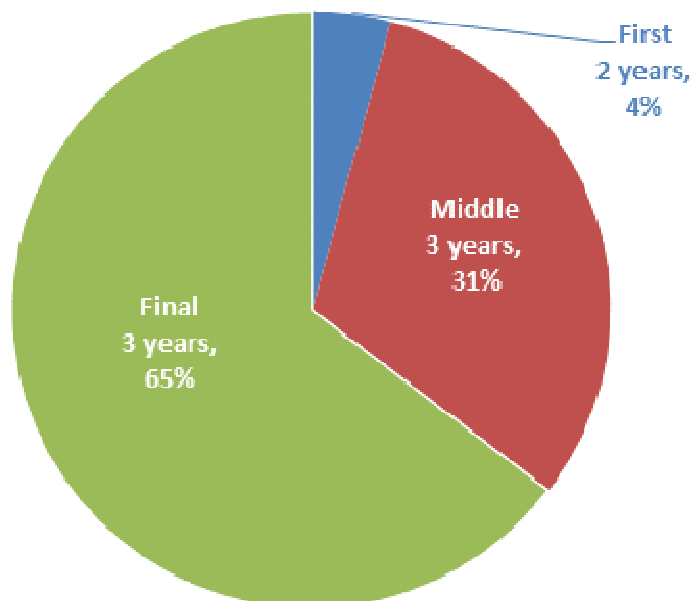
<sup>165</sup> Guardian 27 September 2006.

<sup>166</sup> Sources: DfT and Roger Ford.

under a management contract while, in the meantime, the DfT launched a new invitation to tender for the ECML. In August 2007, the new franchise was awarded to National Express: in December 2007, the line was taken over through its NXEC SPV which walked away less than two years later. The state then took over the line through the hastily assembled team at Directly Operated Rail which has since returned the line to profitability, though the government (in line with its theology) has insisted it will return the line to private operation as soon as possible.

National Express won the franchise with a bid that classically combined a back-loaded premium profile with grossly optimistic projections of passenger numbers and revenues. The company offered premiums of £87m in 2009 rising to £472m by 2015, back-loaded to take advantage of the cap and collar revenue support system which would come into effect after 2011.<sup>167</sup> As exhibit 47 shows, the premium payments for National Express East Coast (NXEC) were back-loaded to such an extent that only 4% of premium payments were due in the first two years, while the final three years – when cap and collar revenue support would be in play – would see 65% of premiums fall due.

**Exhibit 47:** National Express East Coast distribution of premium payments over the life of the franchise (based on nominal cash payments)<sup>168</sup>

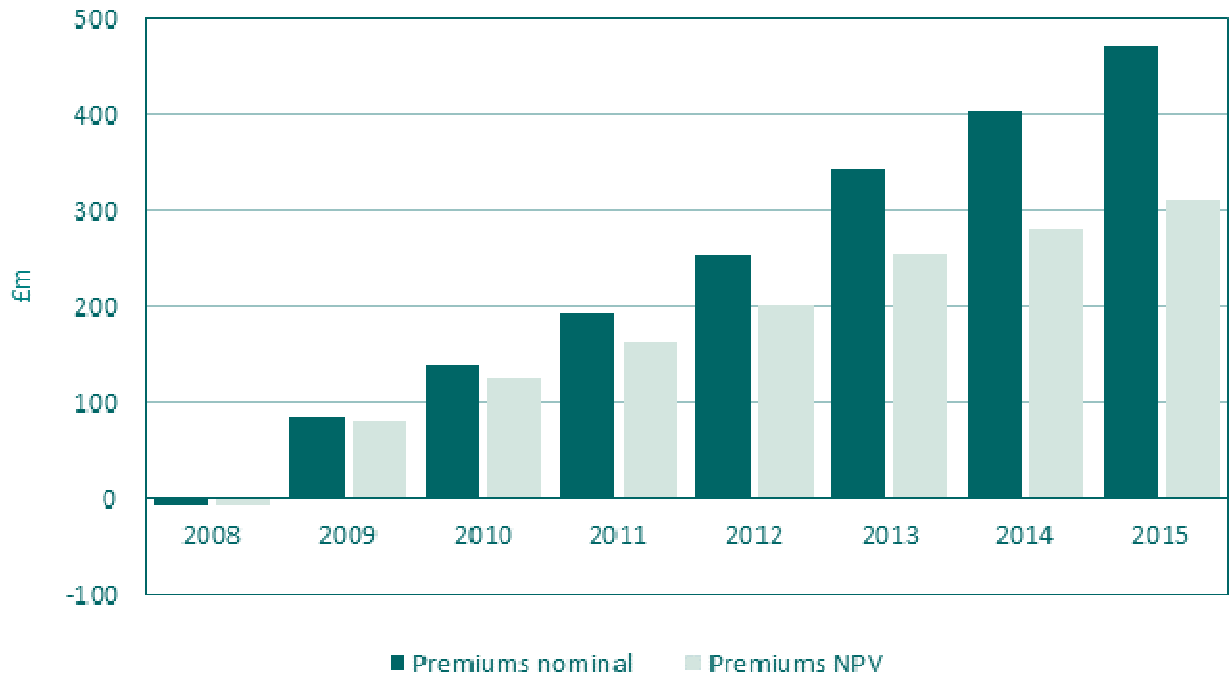


The underlying assumption justifying the ambitious projections was of continuing economic growth so that passenger revenues would rise steeply over the entire lifetime of the franchise allowing NXEC to make large premium payments in later years (as shown in Exhibit 48).

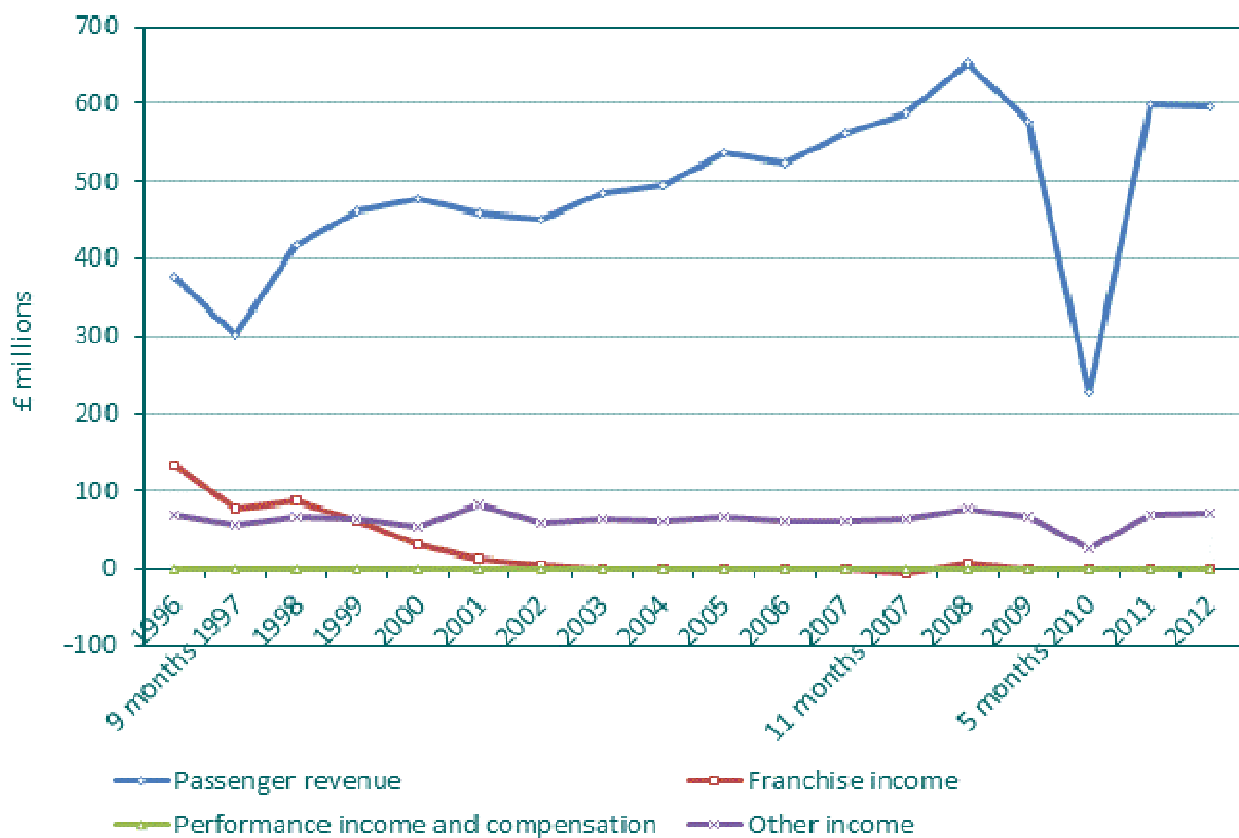
<sup>167</sup> McCartney, S. and Stittle, J. (2011) 'Carry On up the East Coast', 125-9.

<sup>168</sup> Source: DfT.

**Exhibit 48: National Express East Coast premium profile<sup>169</sup>**



**Exhibit 49: InterCity East Coast/GNER/NXEC/East Coast Mainline: Sources of revenue<sup>170</sup> (2012 prices)**



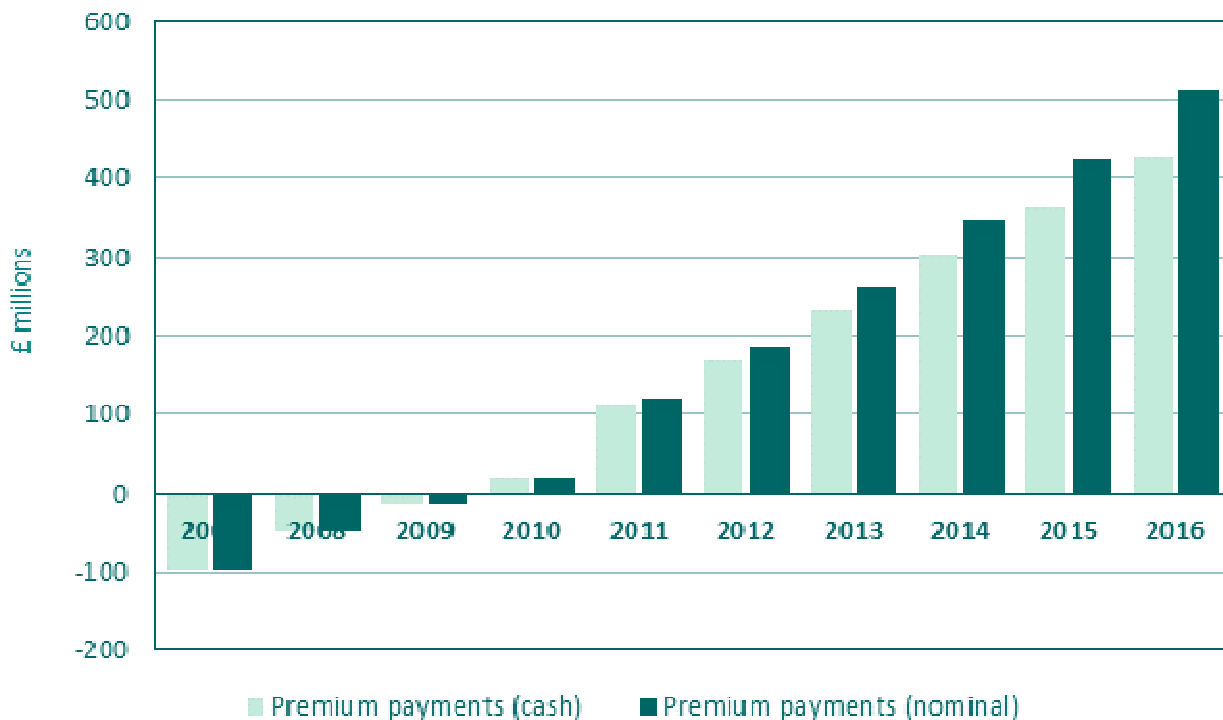
<sup>169</sup> Source: DfT.

<sup>170</sup> Source: Annual report and accounts, various years.

As it was, the bid was awarded just as the UK economy began to turn down into sustained recession. By mid-2009, NXC was making substantial losses because the economic crisis severely dented passenger revenue, as shown in exhibit 49. From 2008, passenger revenues declined steeply, while other sources of revenue were quite stable. By 2011, passenger revenues were back to the 2007 level but the intervening two years of losses created a crisis for the franchisee. With National Express Group unwilling to bail out its TOC and the government unwilling to pay them more subsidy, the franchise was surrendered towards the end of 2009. Despite pulling out relatively early in the course of the franchise, National Express Group lost just £72m from the failure – a £32m performance bond and a £40m subordinated loan.<sup>171</sup> NXC had not turned a profit but National Express had capped its losses by walking away.

The experience with a new franchisee on the East Coast main line in 2007 was reinforced by the experience of a well-established franchisee walking away on the Great Western franchise route in 2011. It was the now familiar story of an original bid which combined back loaded premium payments and gross optimism about passenger numbers. As exhibit 50 shows, the bid was based on the operator, First Greater Western (whose parent company is First Group), being subsidised for each of the first three years, paying a manageable amount in the middle four years, when cap and collar support would kick in, but having a massive amount of premiums to pay in the final three years.

**Exhibit 50:** Premium profile for First Greater Western franchise<sup>172</sup>



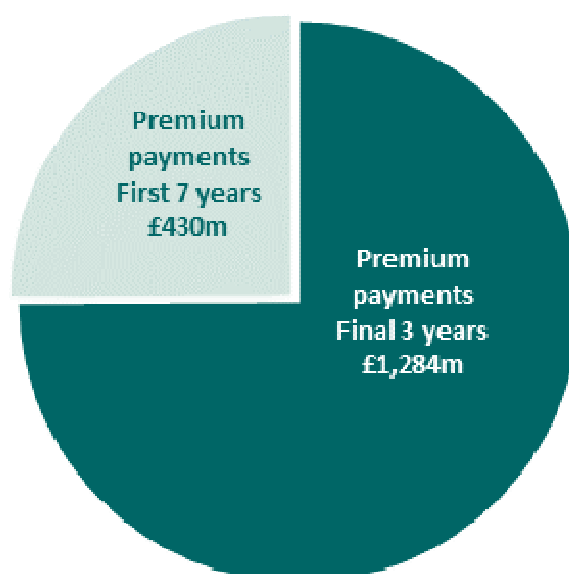
In its successful bid, First Greater Western had predicted revenue growth of around 8% per year and a growth in passenger numbers of over 4% per year. As we discussed in chapter 2, by 2011 First

<sup>171</sup> Peston, R. (2009), 'I could operate trains' BBC News, 01/07/2009. Available at [http://www.bbc.co.uk/blogs/thereporters/robertpeston/2009/07/i\\_could\\_operate\\_trains.html](http://www.bbc.co.uk/blogs/thereporters/robertpeston/2009/07/i_could_operate_trains.html)

<sup>172</sup> Source: Morgan Stanley / Company Data / DFT / Roger Ford.

Greater Western faced recession which pulled passenger revenues below their optimistic assumptions. But the TOC was able to exercise a break clause in the franchise agreement which allowed it to hand back the keys after seven years and walk away without meeting the obligations of the original contract. As exhibit 51 shows, more than three-quarters of the franchise payments to the state were due in the final three years of the franchise agreement. By exercising the break clause, First Greater Western avoided them.<sup>173</sup> First Group did pay penalties but, overall, were not required to pay more than £800 million of premium payments.<sup>174</sup>

**Exhibit 51: Premium to be paid by First Greater Western before and after the exercise of the final three year break clause<sup>175</sup> (Nominal, £m)**



From our point of view, the behaviours described above represent a kind of corporate moral hazard. The bidding process with back loading encourages optimism about passenger revenues and thus taking increased risk, which is no problem to the bidder because the costs can be passed off to the state which is left to pick up the pieces. Predictably, stock market analysts of the TOC's quoted parents are much kinder about such behaviour which, from a corporate point of view, they see as a sensible way of limiting corporate downside exposure. But the interesting point is that, with this

<sup>173</sup> In May 2011 FirstGroup announced it would be exploiting a break clause in its Greater Western contract with the DfT in order to hand back the franchise three years early in March 2013, thus avoiding £826.6m in premium payments promised to the DfT in the original bid. Earlier, following DfT mistakes in the franchising process, FirstGroup managed to win an early onset of Cap and Collar (CaC) subsidy. As the *FT* reported in 2011, 'The group, which will take a £59.9m hit from the decision, said the franchise was making a "small profit", but it had benefited from government subsidies and would be loss making over the next two years. "The extension period would not have been economic," said Tim O'Toole, chief executive. "When the new government came in they indicated they weren't in favour of renegotiations so that really wasn't an option."' *Financial Times*, 'FirstGroup to hand back rail franchise' 11/05/2011. Available at <http://www.ft.com/cms/s/0/54aa9e30-7c06-11e0-9b16-00144feabdc0.html> Virgin too had benefited from similar contractual wrangling: when the WCML franchise was reinstated in 2006 – having previously been run on a management contract as a means of compensation for disruption caused during delayed track upgrades – Virgin was also able to renegotiate CaC subsidy to start early.

<sup>174</sup> The Observer, 13 March 2011. <http://www.guardian.co.uk/business/2011/mar/13/firstgroup-may-abandon-first-great-western-franchise>

<sup>175</sup> Sources: Morgan Stanley and Company Data.

difference of interpretation, the corporate behaviours around back loading are explicitly recognised and openly discussed in analysts' reports. Here for example is a JP Morgan analyst, back In August 2005 discussing two franchise bids including the First Group bid for the Greater Western franchise which ended in 'walk away' in 2011.

*Premium payments back-end loaded for both – into the discretionary contract extension periods: Over the GW franchise life, c £1bn NPV of premium payments are expected to be paid by FirstGroup, but c 75% of this is back-end loaded into the contract extension period in years 8-10. At TL the back-end loading sees c 60% of the aggregate NPV of £808m premiums paid in the contract extension years 7 -9. In our view, this limits some of the risk if demand assumptions prove optimistic – as 68% of premiums are in (to be agreed) contract extension periods. (Our emphasis)*

The curious point is that City investors who take the profit have long known what is going on, but the DfT which pays the cost has been remarkably slow to recognise the problems caused by optimistic revenue projections combined with back loaded payments premiums. When it came to the West Coast Mainline (WCML) tendering process in 2012, the DfT claimed that it had substantially changed the franchising system ostensibly to deal with the balance of risk and reward for state and TOC but actually showed that the ministry had learnt nothing about bid profiles which would quite predictably end in walk away.

## The GDP Mechanism and the new West Coast Debacle

A reform of franchising followed the McNulty review in 2011. The DfT introduced a new revenue-risk sharing system which was to reflect macro-economic externalities and their effect on passenger demand through a GDP Mechanism which was to be calculated by a DfT GDP Resilience Model. Effectively, the DfT added technical complexity to deal with economic cyclicalities and longer-term uncertainty about revenues. The initial bid award of a new West Coast franchise to First Group under the new system could not then be sustained because the DfT had not competently operated its own technical formulae and this was the basis for Virgin's challenge to the FirstGroup bid.<sup>176</sup> But the fuss about the DfT's incompetence conceals a more fundamental point. The initially successful First Group bid was quite rightly thrown out on a technicality because the DfT had got it wrong. More fundamentally, the DfT should have excluded the First Group bid because that bid represented exactly the same combination of revenue optimism and premium back loading which had previously led to walk away problems.

Following the McNulty review, the cap and collar revenue support system was replaced by a combination of two support systems which together offered a form of revenue share that lowered risks to the TOCs. First, a standard revenue share system in operation since 2007 allows the DfT to take an increasing proportion of income from the franchise if its profit increases above the revenue projection. Second, under a new GDP adjustment (GDPA) mechanism, DfT estimates for the vulnerability of different franchises to deviations from projected GDP growth are used as the basis

<sup>176</sup> The system is described in more detail in the original ICWC Invitation to tender document DfT (2012), *InterCity West Coast Franchise: Invitation to Tender*. Available at <http://assets.dft.gov.uk/publications/intercity-west-coast-franchise-itt/invitation-to-tender-main-document.pdf>

for provision of subsidies or the payments of additional premiums linked to movements in GDP.<sup>177</sup> Unlike cap and collar which becomes available only four years into the life of the franchise (and so was not available to NXEC in 2009) the GDPA revenue support system begins from day one of a new franchise.

There was also the good intention of protecting the state from walkaway. The new system was supposed to give forewarning of overbidding by forecasting revenue in downturns as well as the ‘central economic scenario’. As for consequences, a subordinated loan facility (SLF) backed by bank guarantees (alongside a smaller ‘performance bond’ and ‘season ticket bond’) now has to be supplied by the TOCs who lose their deposit if the franchise contract is not fulfilled. The effect of this mechanism depends entirely on the size of the SLF because only a large SLF (probably well into the hundreds of millions of pounds) can provide insurance against walk away which could easily save a billion or more in premium payments on a large franchise.

The size of the SLF depends upon a judgement made by the DfT of how risky a specific bid is: how likely is it that the company will be able to pay to the government the amount it promises over the period (in this case up to 2028) regardless of economic downturns? There is no minimum SLF; instead, models developed by the DfT (based on the GDP Resilience Model) produce a default risk estimate recognising the targeted profit margin and the premium payment schedule. The difference between this risk estimate and the acceptable default risk outlined by the DfT is used to judge the size of the SLF. In the first bid under the new process, WCML Virgin made a prediction of annual revenue growth of 8.5% and was asked for a £40m SLF, whereas First Group more optimistically projected a 10.4% growth in revenue and was asked for £190m as ‘deposit’.

The idea is one of win, win: a new combination of guaranteed profit margin from day one and the SLF as forfeitable deposit would both limit the difficulties for franchisees in down turns and also reduce the state’s risk of walk away. It would also mean that back-loaded bids could still go through the process if the parent company is willing to provide a substantially sized SLF.

How did the new system go wrong in its first franchise competition? Remarkably, according to the Laidlaw investigation set up after the WCML fiasco, the DfT used the version of the GDP Resilience Model developed for the GDP Mechanism to calculate the SLF – while knowing it was not designed for the purpose.<sup>178</sup> It kept the model it used under wraps in the invitation to tender, providing instead a ‘ready reckoner’ of estimates. It proceeded with this, according to Laidlaw, knowing that the lack of transparency left the process open to challenge by the bidders. Bidders did not therefore have adequate information on the size of the SLF penalty requirement and how it could be

<sup>177</sup> The DfT has yet to release full details of the system, and the interpretation is taken from Roger Ford’s briefing from FirstGroup, *Modern Railways*, October 2012. See Go Ahead (2012) ‘Revenue share and support mechanism’. Available at [http://www.go-ahead.com/~media/Files/G/Go-Ahead/storage/pdf/rs\\_support\\_factsheet\\_oct10.pdf](http://www.go-ahead.com/~media/Files/G/Go-Ahead/storage/pdf/rs_support_factsheet_oct10.pdf), and Stagecoach Group (2012), ‘UK Rail Franchise risk sharing’. Available at <http://www.stagecoach.com/investors/financial-analysis/uk-rail-franchise.aspx>

<sup>178</sup> DfT (2012), *Report of the Laidlaw Inquiry into the lessons learned for the Department for Transport from the InterCity West Coast Competition* Available at [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/29866/report-of-the-laidlaw-inquiry.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/29866/report-of-the-laidlaw-inquiry.pdf) and DfT, *The Laidlaw inquiry: initial findings report*. Available at [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/9171/laidlaw-report.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/9171/laidlaw-report.pdf)

accurately calculated, only a confusing approximation. They could not therefore accurately work out the appropriate size of their own bid.

The DfT ultimately did not comply with its own guidelines, as having received the bids it decided that the SLF requirement should be determined in reference to the ready reckoner rather than the GDP Resilience Model – in other words, while promising an accurate estimate based on a mathematical model, they delivered a ‘reckoner’. The reckoner was itself technically ‘flawed’, according to Laidlaw, because the GDP Resilience Model was not converted from real to nominal prices: all SLF estimates were given in 2010 prices, thereby drastically reducing the SLF requirements outlined in the ready reckoner. Both Virgin and First were required to provide SLFs which were smaller than they should have been.

According to Laidlaw, the fault in all this was with the DfT which was not doing its job properly. Rushing to meet the latest reworking of the franchising system, the DfT’s new approach was ‘developed late, in a hurry and without proper planning and preparation’. This was made worse by the fact that the DfT had undergone ‘a significant reduction in size’ and ‘frequent changes in leadership’ while the DfT workload expanded. The DfT’s franchise team for the WCML was ‘relatively junior and inexperienced in comparison with the bidder team they were facing’ – reliant on external consultants for financial expertise, the funding for which had now been cut.<sup>179</sup>

### Technical error or fundamentally flawed?

The £190 million SLF required of First Group was ludicrously low and provided no insurance against walk away when First Group was promising to deliver £13.3bn to government in premium payments over the life of the franchise and make £739 million per annum premium payments by 2026. But there are more fundamental questions. Even if the DfT had organised the bidding process with greater competence and the SLF had been two or three times as large, that SLF would have been smaller than one year’s premium payments in the later years of the franchise. And, leaving aside the forfeitable deposit, the fundamental risk of walk away was very high indeed because First Group unacceptably replicated the old pattern of optimism about passenger revenues and back loaded premium profiles.

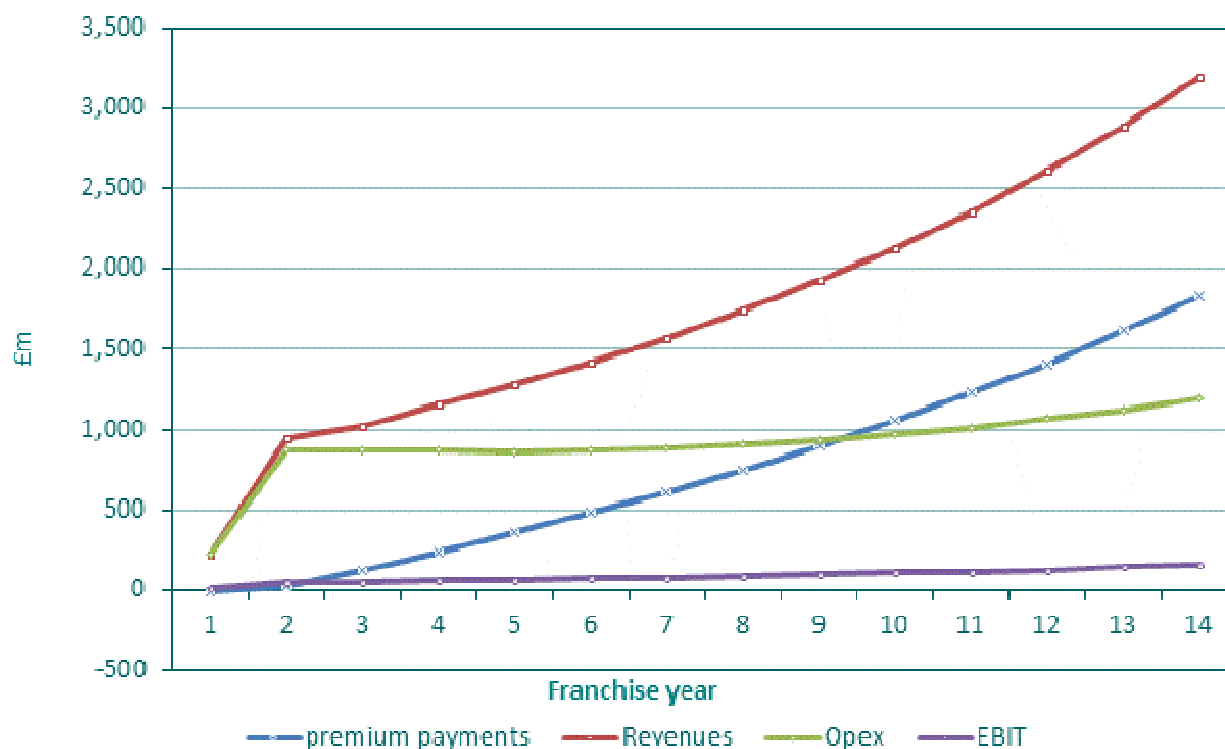
The total net present value of the premiums to be gained by the government from the First Group bid for the WCML bid was an impressive £5.5bn. This headline figure was triumphantly announced by the DfT and First Group, and faithfully reproduced by the press, as proof of the public value to be gained from the franchise. But, timings of the payments are just as significant as the total and the First Group’s bid premium profile appears not to have been publicly disclosed. While franchise agreements specifying outputs are publicly available, bid documents including financial promises are ‘commercially confidential’. Nonetheless details of the WCML bid have emerged in the trade press and in analysts’ reports from major investment banks, so we now know that the winning premium profile offered by First Group for the WCML is near identical to those of the doomed ECML and Greater Western franchises.

The assumptions underpinning the steep premium profile shown in figure 52 were a heroic 10.4% nominal revenue growth rate and growth in passenger volume of 5.8% per year. This growth,

<sup>179</sup> *The Laidlaw inquiry: initial findings report*, p. 18.

FirstGroup claimed, would be achieved through better marketing and yield management.<sup>180</sup> This in turn was based around the assumption that GDP would grow over the next 14 years at an average rate of 2.5% a year – a reversion to mean forecast growth rates that was attributed to the DfT. First’s projected profit margin of 5% per annum would ensure that shareholders would see the benefits, with a steady growth in earnings before interest and taxation from £11m in the first year of the franchise to £160m in the last. This would yield a cumulative total of £1.2bn of net profits which, if the pattern of other franchises was followed, would have all been stripped out as dividends.

**Exhibit 52:** First Group’s winning bid for the WCML<sup>181</sup> (Nominal, £m)<sup>182</sup>



While the bid looks startlingly ambitious, it is worth considering briefly the kind of pressure from the stock markets which PLCs like First Group come under. Take for example this analyst report from JP Morgan on August 15 2012, the day the First Group victory was announced:

*The bid looks sensible to us. We believe this should go a long way to allaying fears in the market that balance sheet issues would see FGP to overbid for the franchise ... we see the 5% EBIT margin as somewhat disappointing ... Indeed, we see potential for outperformance.*<sup>183</sup>

<sup>180</sup> Roger Ford, 'Informed Sources' in *Modern Railways*, October 2012.

<sup>181</sup> Company data and Morgan Stanley. Note: OPEX refers to operating expense required for daily operation.

Notes: Opex = operating expenses; EBIT = earnings before interest and taxation

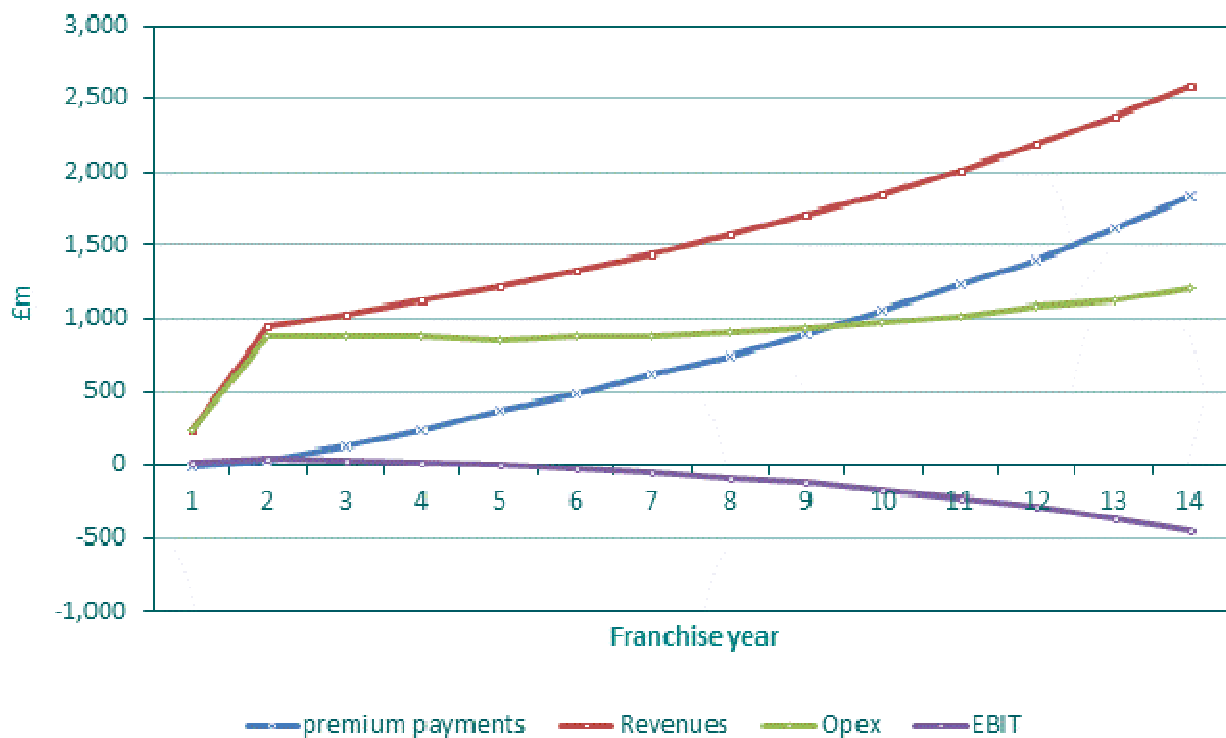
<sup>182</sup> OPEX refers to ongoing costs incurred by Network Rail to maintain the railway infrastructure. Examples of OPEX include routine safety checks on the railway tracks or repairing signalling. It excludes capital expenditures typically referred to as CAPEX. <http://www.rail-reg.gov.uk/server/show/conGlossary.224>

<sup>183</sup> JP Morgan Cazenove, Europe equity research: UK public transport. 15/08/2012.

They would have been seriously downcast by Virgin's slightly more modest bid, with a NPV of 4.8bn based upon average annual revenue growth of 8.5% a year, with fluctuations to take into account drops in passenger growth resulting from construction work at Euston for High Speed 2.

Virgin's bid was still very optimistic as regards passenger and revenue growth, but it is illuminating to consider what would have happened to First's West Coast franchise had the revenue growth through the franchise period run at Virgin's estimates, with the same premium profiles and the same operating expenditure. This is shown in exhibit 53, derived from Morgan Stanley estimates.

**Exhibit 53:** First group's winning bid using assumptions based on Virgin revenue growth bid with same premium profile and same OPEX<sup>184</sup> (Nominal, £m)



In this scenario, First West Coast would see their profits begin dipping deep into negative territory after seven years. Given the low original required SLF, the temptation to walk away from the franchise would be strong because First Group would have only put in a mere £10m in equity, a £190m SLF and £65m in bonds. Assuming however that for the first six years First West Coast had achieved its EBIT of £305m as outlined in the first scenario above in exhibit 52 and, as is the custom among the TOCs, taken it all out as dividends, it would still have made a profit on the franchise of £40m even if it lost all the £265m tied into the venture.

All this was of course well understood in the City. Take for example this comment from RBC Capital Market in a note discussing the First Group franchise bid for the West Coast main line:

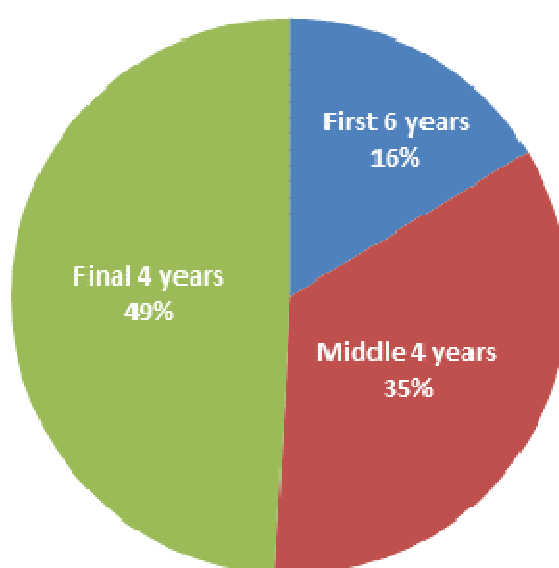
*We still think the bid-in 10.4% revenues CAGR is aggressive, but the key is the non-linear premium payment profile. This affects the reward/risk tipping point in the contract. If profits go off-course early on, then maximum downside would be the walk way capital at risk. If the*

<sup>184</sup> Source: Company Data and Morgan Stanley.

*contract did deliver approx. £50m pa EBIT (so £38m post tax), then if FirstGroup walked away at any point after 6.8 years the operator would still be net up. (Our emphasis)*<sup>185</sup>

Here we see, after analysts' meetings with corporate parents, open discussion for investors about: the benefits of back loading in terms of reducing risk to the franchisee; the probability that late franchise payments will never be made; and the certainty of 'net up' outcomes. But, curiously, this is rarely discussed as a matter of public interest in the mainstream press nor often investigated as a public interest issue by the transport or public expenditure select committees. This is quite remarkable, when as exhibit 54 shows, in net present value terms, First's bid has only 16% of premium payments due in the first six years, compared to 49% in the final four years.

**Exhibit 54:** First Group WCML bid distribution of premium payments<sup>186</sup> (%)



The public interest problem on the West Coast main line is not that the DfT has retreated into technicalities, cannot get its sums right (and needs to recalculate). The problem is that the DfT could not see that the meagre sum of a £190m SLF, a £5m season ticket bond, a £45m performance bond, a £15m station repair guarantee and £10m of equity was altogether insufficient to prevent First Group opting out of the franchise to avoid its multi-billion pound premium commitments in the final years of the contract. Moreover, this inherent problem of long term franchises with heavy back loading of premiums requires not a higher deposit but fundamental rethinking of the franchise system.

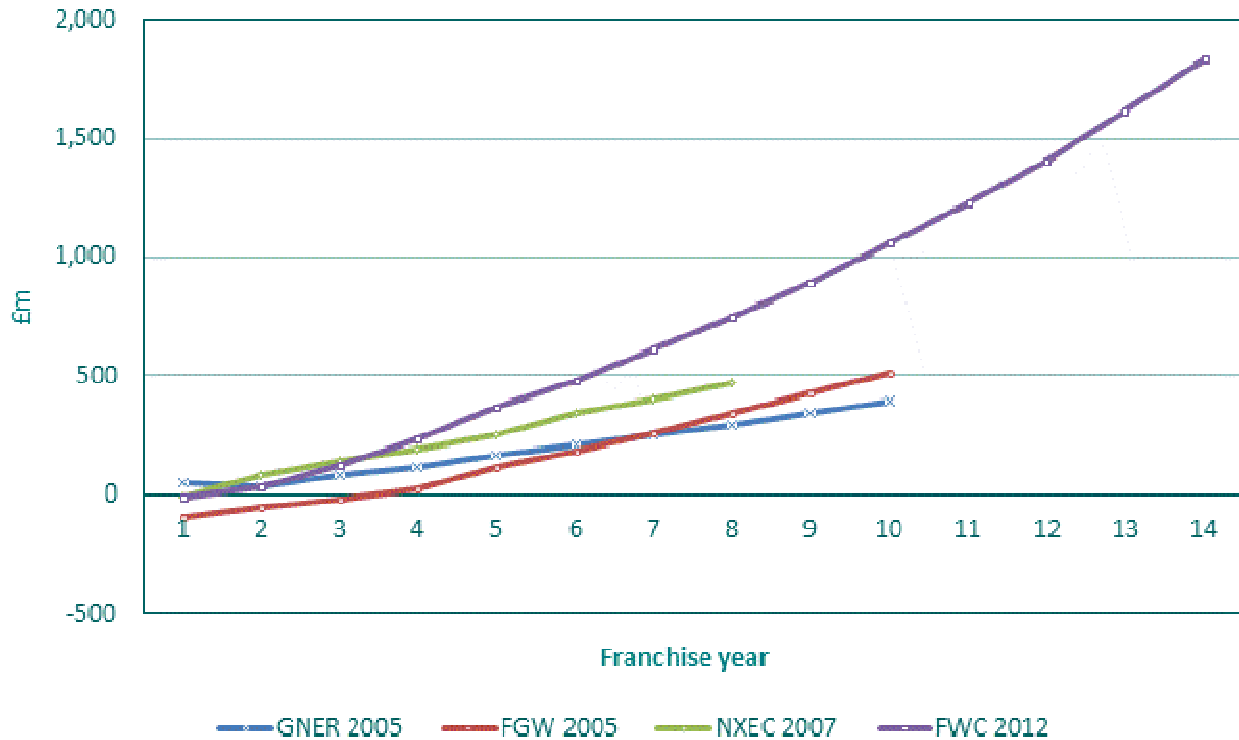
In effect, the public was bamboozled because the initial award to FirstGroup was not overturned after debate about the unreality of First's figures followed by questioning of optimistic projections and promises of premiums which were unlikely to be paid; instead the DfT's procedural irregularities and miscalculation of the SLF provided the basis for challenge by Virgin's lawyers. The

<sup>185</sup> RBC Capital Markets, Equity Research, 15/08/2012.

<sup>186</sup> Source: Company Data and Morgan Stanley.

real scandal here was not the technical incompetence of DfT staff in calculating the SLF, but the department's unwillingness to learn from past franchising disasters and its continued willingness to accept heavily back loaded bids based on absurdly optimistic revenue projections.

**Exhibit 55:** Comparison of premium profiles in failed franchises<sup>187</sup>



As exhibit 55 shows, the First West Coast bid (made after the recession) was even more optimistic than the failed GNER, NXEC and First Greater Western bids (made before the recession). In this economic context, the 2012 First West Coast bid is much *more fantastic* than the three previous failed franchises shown here. The projection for growth in premium payments is steeper and the period of time over which growth is expected to continue is considerably longer. This not only increases the element of uncertainty but adds to the element of unreality because as of 2011-12 there is no realistic macro prospect of 2-3% sustained economic growth driving increases in passenger numbers.

McCartney and Stittle rightly return to the old question of whether 'competition for a market' rather than 'competition in a market' is thus the natural solution to monopolies.<sup>188</sup> From the past decade's experience of franchising, the answer is 'definitely not', because in rail franchising this competition for markets incentivises TOCs to secure franchises by gaming the system. In doing so, they exploit the generosity of a weak DfT and the absence of effective public scrutiny.

<sup>187</sup> Sources: Morgan Stanley, Company Data, DfT, Roger Ford. FGW, NXEC and FWC are presented as nominal. GNER is presented in cash terms as calculated by Roger Ford, due to the unavailability of the original nominal figures.

<sup>188</sup> Quote taken from McCartney, S. and Stittle, J. (2011) 'Carry On up the East Coast'

## The Brown review: keeping up appearances

These accumulated mistakes would, one might reasonably expect, severely undermine official faith in the suitability of franchising for the railways, but this has not been the case. Nothing demonstrates the resilience of the political framing of the benefits of privatisation quite like the Brown Review of rail franchising, commissioned in the wake of the 2012 West Coast Mainline fiasco.<sup>189</sup> The debacle should have given pause for thought and allowed space for a thorough review of the franchising system carried out by disinterested parties with a remit allowing them to pose difficult questions and propose radical changes. Instead, the Secretary of State tasked Richard Brown, chair of Eurostar and a former chair of ATOC, to come up with recommendations on ‘how to get the other franchise competitions back on track as soon as possible’.<sup>190</sup>

The review itself then was a foregone conclusion from the start – with ‘getting franchising back on track’ practically elided with ‘giving the TOCs what they want’. Since a major change to franchise policy was not on the cards, the most predictable recommendation from Brown was for capacity strengthening and organisational tinkering at the DfT. More unexpected was his recommendation that specification and oversight of franchises would be carried out by local passenger transport executives. It was not clear where the funding for this kind of expertise at a local level would come from in the current environment, so this proposal appears mainly a nod to the Coalition’s agenda of localism without resources.

The other significant proposals contained in the report all relate to measures designed to benefit the TOCs by further reducing the already low risks of operating a franchise. Brown proposes that the DfT focus on having an array of smaller franchises rather than continuing the trend of consolidation towards ‘mega-franchises’, while keeping franchise duration short – in the range of 7-10 years rather than the 14-15 year franchises post McNulty. The rationale being that such changes would reduce risks for the TOCs which could hope to build a diversified portfolio of operations rather than being exposed to single large franchises in make or break situations.<sup>191</sup> Related to this, he suggests that franchises should not bear cross default risks – meaning that failure in one franchise will not impact upon a company’s other franchises. The lowering of barriers to entry and exit in this manner could be expected to bring new entrants into the tendering process, thus upholding the market imaginary.

Default therefore in Brown’s view, should not be a disaster which government should avoid at all costs, but measures to make it less likely should be implemented. He recommends that,

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<sup>189</sup> DfT (2013) ‘The Brown Review of the Rail Franchising Programme’. Available at [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/49453/cm-8526.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/49453/cm-8526.pdf)

<sup>190</sup> DfT (2012), ‘Text of letter from the Secretary of State to Richard Brown 15 Oct 2012’. Available at [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/9197/letter-to-richard-brown.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/9197/letter-to-richard-brown.pdf)

<sup>191</sup> *Ibid*, 2.14.

*Capital requirements should be set at a level to create financial robustness, deter default and protect Government up to a reasonable limit for loss of premium or increase in support in the event of any default.*<sup>192</sup>

This is of course suitably vague, and no different to the language used about higher capital requirements and penalties in earlier reports on rail franchising reform. The dilemma remains that, if the capital requirements were high enough to expose a franchisee to anything like the *full* costs of default, nobody would bother bidding. As Brown writes, ‘Set too high, the capital requirement becomes a substantial barrier [to entry]’, and would also serve to limit the premium payments government could receive.<sup>193</sup> Or, as we would put it, the requirements of the simulacrum now prevent effective reform of franchising at the expense of TOCs.

More relevant to the issue of walk away is risk reduction for the TOCs through the measures Brown proposes to provide TOCs with full insulation from exogenous risks. This goes beyond the ‘cap and collar’ mechanism introduced by the SRA in 2003, and the GDP mechanism built into the WCML franchise:

*Franchisees should be responsible for risks they can manage and should not be expected to take external macroeconomic, or exogenous, revenue risk; there should be a clear mechanism to adjust franchise premium/support payments for variations in Gross Domestic Product (GDP) and Central London Employment (CLE) growth rates.*<sup>194</sup>

The public interest rationalisation is that such reforms would limit the scope for gaming the system by projecting over-optimistic bids based on high GDP growth. It would also allow operators to focus on reducing costs while bidding with lower margin requirements, as no cushion is required to manage unforeseeable external risks. The mechanism would be to adjust premiums or support payments according to changes in a set of indices covering the full range of exogenous factors. With virtually all risk removed and guaranteed profits, this kind of franchise moves towards resembling a management contract. But Brown rules these out as unsuitable on the grounds that the TOCs would therefore lack incentives to grow volume and improve the service: TOCs must retain their option on super-normal profits as and when they arise (albeit with a profit share mechanism whereby government takes a proportion of the excess).

One suspects that the friendliness of the report to the TOCs stems not simply from Brown’s insider status, but also by his report’s methodology: the Brown report is light on empirics and statistical research, and pulled together primarily from stakeholder interviews carried out over a two month period – and the single largest category of interviewee is of course the TOCs.

No doubt the DfT does lack expertise as the Laidlaw and Brown reviews allege. But the more fundamental problem is that the DfT is not in the traditional adversarial role of a county council surveyor putting a bridge building job out to contract. The DfT is in a co-dependent role because its simulacrum depends on keeping the franchise system going in a way that puts it under control of corporates, which require profit without risk before they will play along. Thus, one way or another,

<sup>192</sup> *Ibid*, para. 1.15

<sup>193</sup> *Ibid*, para. 3.5 – 3.7.

<sup>194</sup> *Ibid*, para. 1.14.

high levels of subsidy are provided to give TOCs with existing franchises an option on profits; and new franchise bidders must be encouraged with generous conditions and DfT suspension of disbelief. It is all now about the simulacrum as a way of performing the imaginary about privatisation. Enough bidders must queue up following the invitation to tender so that it appears that a healthy competitive process is underway which delivers maximum value to the taxpayer, though it is far from certain that public value for money over the life of the franchise will be realised.

It is clear that longer franchises (as currently planned) make the situation worse by increasing the speculative element. Shorter franchises might increase accountability and the realism of bids, but leave the TOCs with no incentive to invest or take a long-term interest in the health of the industry as a whole. Thus franchising is stuck in a contradiction.

## Chapter 6 – The case for the defence

### **Charge 4: The TOCs' public service defence is a farrago of half-truths.**

The TOCs have a trade association, ATOC, whose role is partly to produce a narrative about train operating as a public service. Specifically the TOCs claim credit for the increase in passenger numbers since privatisation and cite passenger surveys showing satisfaction with service punctuality and staff service.

But passenger numbers are a dependent variable (driven by GDP growth and other factors), as acknowledged in the new franchise revenue sharing mechanisms; while passenger surveys register the opinions of consumers of services and do not identify the public interest or recognise the public's view of how the railways should be owned and managed.

In an earlier and more innocent era, private companies behaving badly, like the coal owners, got on with their business, faced down their organised workforce as necessary and lobbied parliament to get their way on regulation. Consider, for example, the Amalgamated Anthracite combine founded in 1923 in Swansea to monopolise specialist coal production from the western margins of the Welsh coalfield. The combine did advertise its product widely (and with some imagination) in the press as a smokeless, sootless coal. But the combine did not retain consultants to issue press releases to explain that the benefits of Aga cooking depended on anthracite fuel, nor did the combine, in its major export market, hire market researchers to measure how satisfied French stove owners were with Welsh nuts.

In our own time, the monopolising combine is outlawed by competition policy, organised workers seldom trouble employers and the trade association of independent firms has acquired a new role. The trade association must now not only coordinate the lobbying efforts of individual firms but also directly influence public opinion. Sectoral influence is now a matter of hiring PR firms and consultants to get your narrative defence in first. As we have argued in earlier work on London finance, this is done by endlessly repeating and up-dating a story which is mostly half-truth. The

story classically explains how the industry produces many social benefits, claims the credit for whatever is good (and glosses over the dark and negative).

So it is with the Train Operating Companies which have a trade association, ATOC, which on its website and elsewhere lists the many benefits that flow from the better services provided by profit motivated private owners. In this narrative, the TOCs attract increasing passenger numbers, offer different passengers value for money fares and even make the trains run on time.<sup>195</sup> The narrative is a powerful one which, if repeated often enough with conviction, will persuade most journalists and policy makers. And it is then copied into official reports like the Brown Review.

*Since privatisation, Britain's railways are successfully carrying more passengers, more safely, on many more and newer trains, more of which arrive punctually and with greater levels of passenger satisfaction. Passenger numbers have grown by 92% since privatisation and Britain has enjoyed the fastest rate of growth amongst major European railways. Britain's railways are now the second safest in Europe; punctuality and passenger satisfaction are running at much improved levels ... Franchising is an important component of the privatised industry structure, and it is highly unlikely that these successes could have been delivered if franchising was fundamentally flawed ... It is very important that the franchising programme is restarted as soon as possible...*<sup>196</sup>

These claims are hugely significant since, as the above extract shows, the acceptance of the claims frames and limits the options for reform. This chapter disputes these claims point by point, mainly by contextualising them, challenging causal attributions and drawing attention to internal contradictions. It is true that, as the TOCs claim, customer satisfaction is at an all-time high based on survey evidence. But the rail sector's composite measures of satisfaction conceal as much as they reveal while a consumerist framing of the customer satisfaction issue also diverts attention from other fundamentally important issues like subsidy and ownership where, according to opinion polls, the public also holds strong views which do not necessarily favour TOCs.

The clear opinion poll majority in favour of rail nationalisation suggests the British are not completely bamboozled by the trade narrative of the ATOCs. They may not understand all the complexities of the rail system but their preference for nationalisation reflects suspicion of and disillusion with privatized rail. The chapter therefore ends by observing that the East Coast Main line under direct ownership provides a crucial test case for the comparison of private and public management. The exemplary record of the line under direct state ownership suggests that good management can be provided without any profit incentive.

## Passenger numbers and journeys

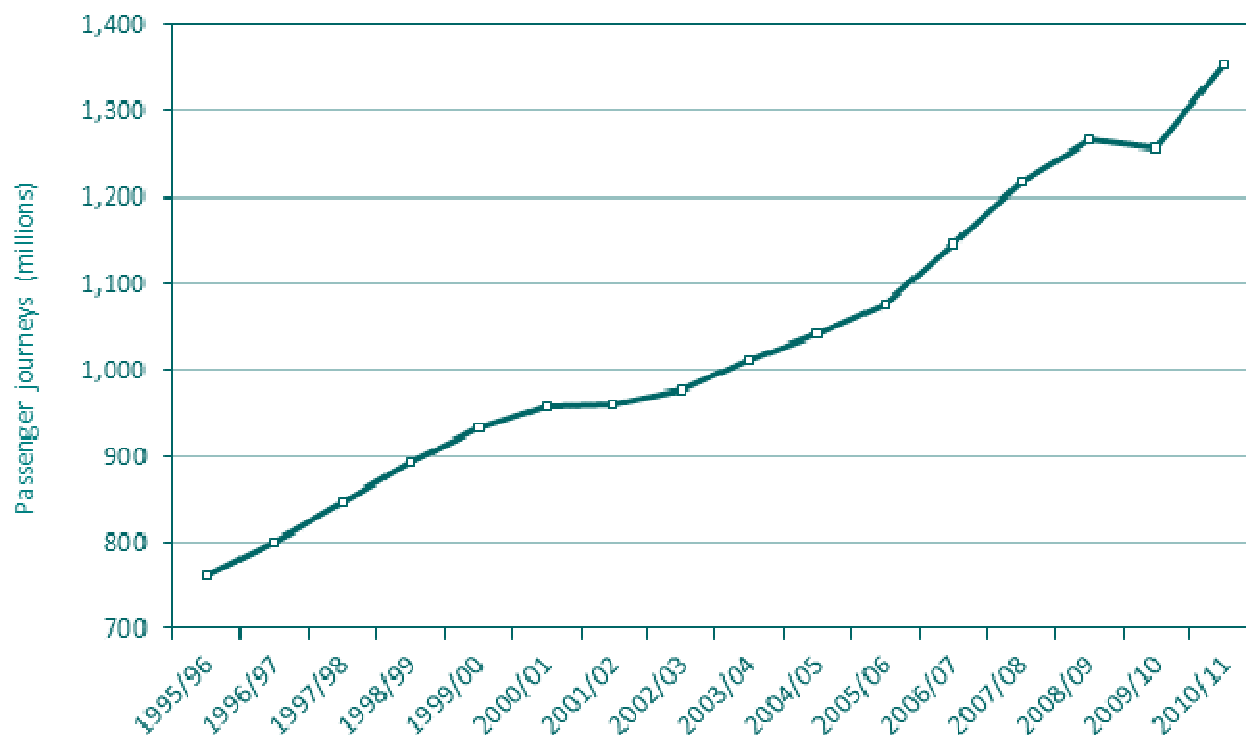
The ATOC defence is initially impressive, and hinges first and foremost upon the increase in passenger numbers since privatisation. As exhibit 56 shows, annual rail passenger journeys have risen from 761m in 1995/96 to over 1300m in 2010/11. If the rail system under privatisation is not transformed for the better, why have so many more people decided to use it since privatisation?

<sup>195</sup> The policy briefings containing these claims are available here <http://www.ato.org/policy-briefings>

<sup>196</sup> DfT (2013) 'Brown Review' Para 1.5.

The increase in usage represents a remarkable increase and turnaround in trends. As railway history buffs will know, British people have not used the railways this much since the 1940s. Prior to 2003/04, the last time more than 1000m journeys a year were taken was 1961. The UK passenger rail system, according to ATOC, has been the fastest growing in Europe over the past decade.<sup>197</sup>

**Exhibit 56:** Passenger journeys by train, annual from 1995/96<sup>198</sup> (Millions)



ATOC gives the private sector the credit for the achievement in its numerous policy briefs. For example:

*The franchising process puts passengers first. It creates a strong incentive for train operating companies to attract additional passengers to maximise revenue... A nationalised industry would have been hard-pressed to move as fast as the TOCs to expand services once demand began rising from the mid-1990s.*<sup>199</sup>

*Rail privatisation has provided a framework that has allowed train operators to meet the needs of their customers with more frequent and attractive services, with new or refurbished trains which, properly marketed, have been able to attract record levels of passengers.*<sup>200</sup>

However, ATOC presents no evidence to show how or why a nationalised rail system would have been 'hard pressed' to expand if it had been subsidised to the extent that the private companies were. Instead it falls back on John Major's argument that a nationalised system would have been starved of investment funds; and, in the quotation below, misleads the reader because a subsidised

<sup>197</sup> ATOC, 'Capacity - ATOC's view' <http://www.aTOC.org/clientfiles/File/capacity2012.pdf>

<sup>198</sup> Source: DfT

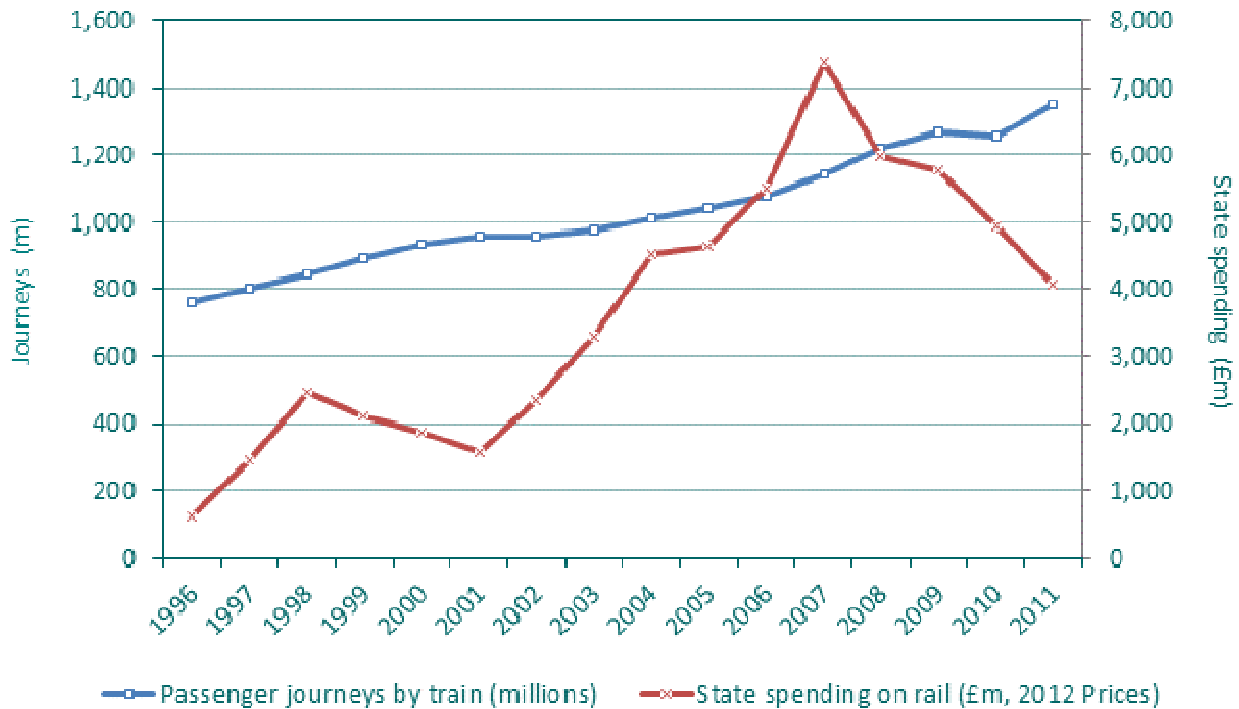
<sup>199</sup> ATOC, 'Franchising – ATOC's view'. Available at <http://www.aTOC.org/clientfiles/File/Policydocuments/Franchising2010.pdf>

<sup>200</sup> ATOC, 'Industry structure and privatisation – ATOC's view', available at <http://www.aTOC.org/clientfiles/File/Policydocuments/IndustrystructurePrivatisation.pdf>

private industry does not increase the PSBR only because it substitutes for this loan guarantees to Network Rail which represent just as much of a liability to the tax payer. ATOC claims that nationalisation,

*...would preclude competition and restrict funds for investment. It could mean that the whole cost of providing national rail passenger services would fall on Public Sector net borrowing, with a significant effect on public finances.*<sup>201</sup>

**Exhibit 57:** Passenger journeys by train vs. state spending on rail since 1996<sup>202</sup> (money values in 2012 prices)



Those who have read the earlier chapters of this report will also appreciate that, although the ‘whole cost’ of the privatised railways does not fall on the state, a substantial proportion of it does. This is the point made by exhibit 57, which shows the growth of passenger numbers since 1996 and officially measured state spending on railways - that is, net grants to TOCs and Network Rail - as recorded by the ORR. State spending on the railway is, in real terms (i.e. after adjusting for inflation), six times higher today than it was at the start of the privatised system in 1996, with the TOCs benefiting from an explosion in state spending from 2001 onwards as the state bit the bullet and started paying for new infrastructure to make up for the failure of privatised infrastructure provision. Without multi-billion subsidies, the TOCs could not have provided the ‘more frequent and attractive services’ which are supposed to have attracted new customers.

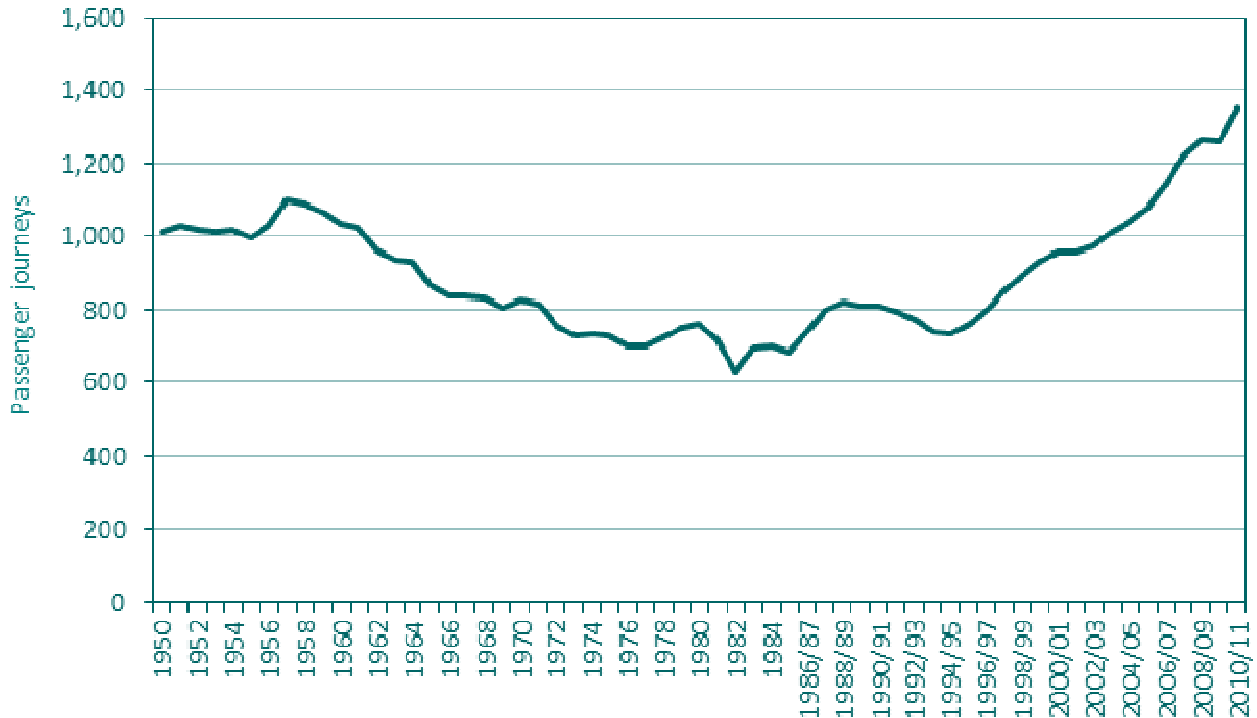
But there is a more fundamental reason to question ATOC’s claims. It is certainly difficult to believe the claim that the private sector deserves the credit for the increase in passenger numbers if we take a closer look at the historical trends in passenger numbers over the past half century. As exhibit 58 shows, passenger numbers have been on a sustained upward trend since 1982, aside

<sup>201</sup> *Ibid.*

<sup>202</sup> Source: DfT / ORR.

from a blip in the recession of the early 1990s. In historical perspective, the turning point comes a decade before privatisation and, if policy has any role, the key change would be the Thatcher government's introduction of New Public Management techniques to British Rail.

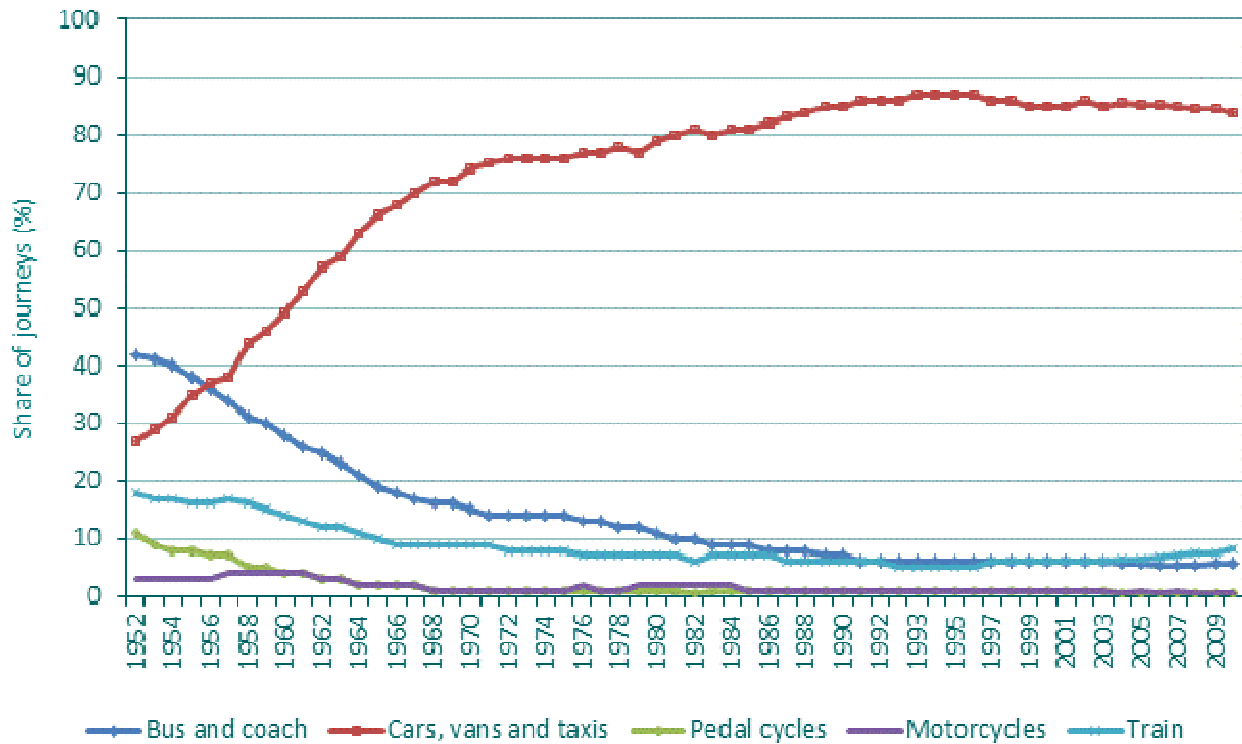
**Exhibit 58:** Passenger journeys by train, annual from 1950<sup>203</sup> (Millions)



In any case, the total number of passenger journeys (as cited by ATOC) is a just one indicator and it can easily become a misleading measure of the historical success and failure of rail transport if we do not factor in drivers like growth of population or income, and if we do not consider the context like the mix of journeys by different modes of transport. ATOC's claims gain plausibility by the decontextualisation of one headline indicator in a way which is as uninformative in rail as it would be in any other sector. For example, we would think it ridiculous for a house builders' association to claim the credit for the increasing number of one and two bedroom flats in the 2000s without factoring in the rise in the number of households and the expense of buying a three bedroom house.

If we shift from total numbers of journeys, to rail journeys as a percentage of total passenger journeys, the picture of rail's comeback under privatisation immediately looks very different. As exhibit 59 shows, there has been a modest increase in the percentage of journeys taken by rail in recent years, but the massive relative decline of the 1950s and 1960s has not been reversed so that railways continue to account for a much smaller proportion of all journeys than they did in the 1940s heyday. Rail has, however, held its share since the 1980s as the share of cars, vans and taxis has levelled off.

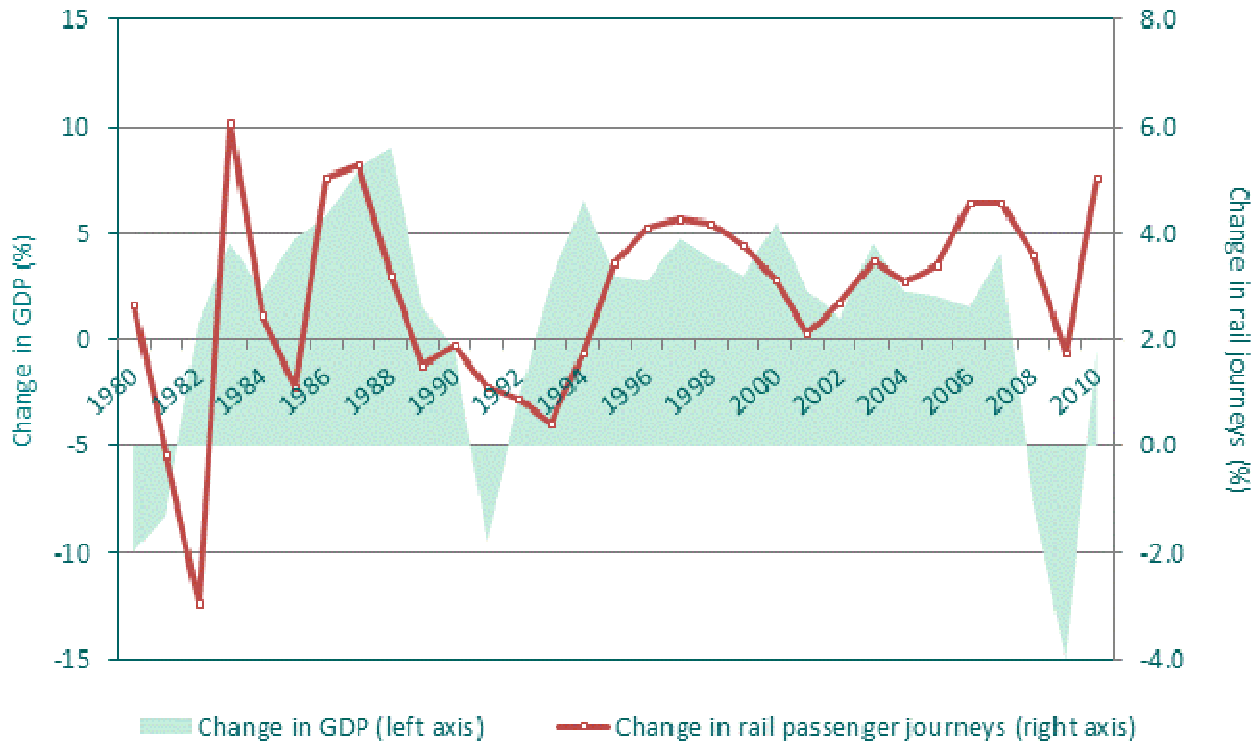
<sup>203</sup> Source: DfT.

**Exhibit 59: Passenger transport by mode, annual from 1952<sup>204</sup>**

More fundamentally, passenger numbers on the railways are determined by more than just quality of TOC customer service and interior décor on the trains. Economic growth is the key driver of secular and cyclical trends in aggregate passenger numbers because rising incomes increase mobility. If we disaggregate the national numbers, intra-regional trends such as housing prices in London and the outer South East are important drivers of passenger journeys at a sub national level. Furthermore, the relative costs of rail journeys *vis a vis* other modes of transport will be an important influence right across the economy.

Privatisation of the railways coincided with the longest period of sustained economic growth in the post war period. As exhibit 60 shows, over the past thirty years there has been a strong positive correlation between year on year rate of growth in GDP and rate of growth in rail passenger journeys so that, for example, recessions in the early 1980s, 1990s and 2008 onwards all reduced the number of passenger journeys (although the effect is much less marked in the recent recession). In our view, this kind of correlation would most likely have existed, whatever the form of ownership.

<sup>204</sup> Source: DfT.

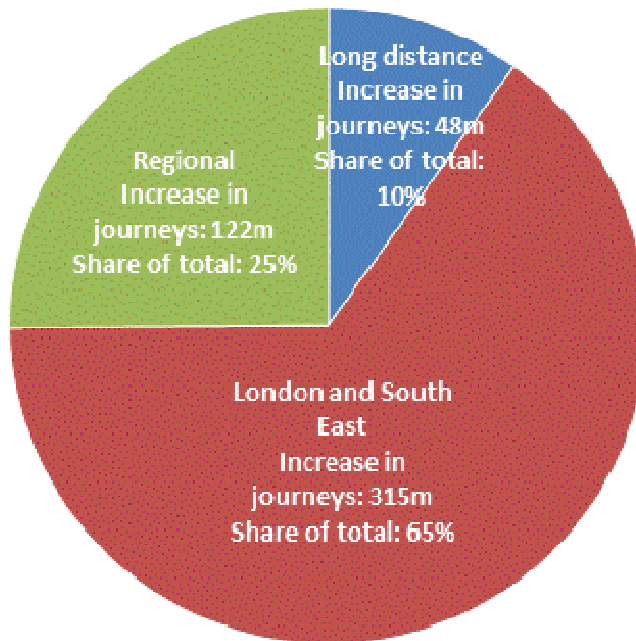
**Exhibit 60: Percentage change in GDP vs. change in rail passenger journeys<sup>205</sup>**

Once this linkage point is accepted, ATOCs attempt to claim the credit for increasing numbers becomes quite implausible. The TOCs were, in terms of passenger numbers and revenues, the windfall beneficiaries of an unprecedented period of sustained economic growth from the mid-1990s up until 2008 when rising incomes could be expected to result in a steady increase in rail passenger journeys. And as we shall see below, this national dynamic was powerfully reinforced by intra- regional effects in the South East and by national trends in the cost of rail versus other journeys.

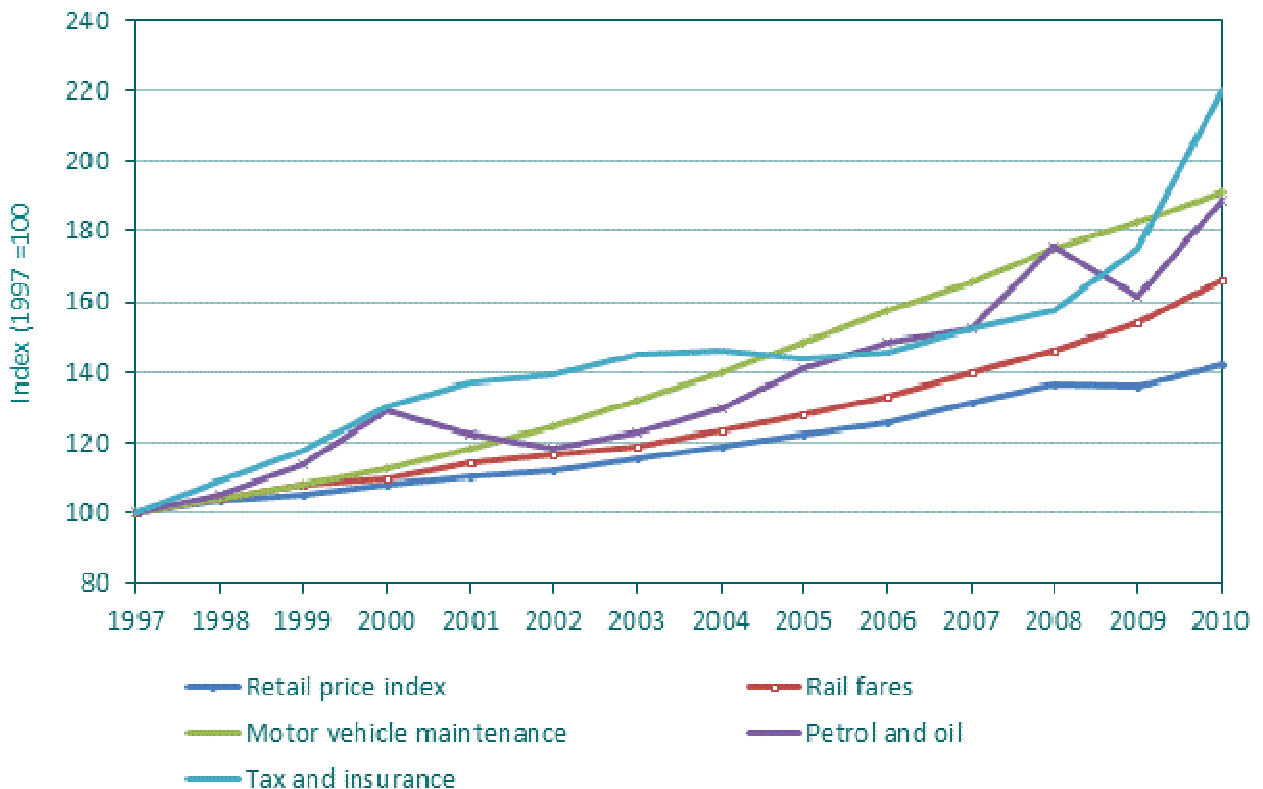
The financial services boom centred on London and its accompanying property bubble encouraged rail commuting from the South East suburbs by those who could no longer afford to buy housing nearer the city centre. The earliest point from which regional splits in rail traffic are available from the ORR is 2002. As exhibit 61 shows, 65% of the subsequent increase in total passenger journeys came from London and the South East where the intra-regional commuting effects were strong.

<sup>205</sup> Source: ORR / DfT / IMF.

**Exhibit 61:** Source of increase in rail journeys by sector since 2002/3 – 2011/12<sup>206</sup> (millions)



**Exhibit 62:** Change in the cost of motoring vs. change in rail, 1997-2010<sup>207</sup>



The final point to bear in mind here is the rising costs of other modes of transport in relation to rail. Exhibit 62 above compares the changing cost of those motoring expenses which are included in the

<sup>206</sup> Source: ORR.

<sup>207</sup> Source: ONS.

retail price index with the changing cost of rail fares relative to the retail price index. All three of the major motoring expenses included in the RPI has increased at a faster rate than rail fares in the period since rail privatisation. Compared to the 66% increase in rail fares between 1997 and 2010, the cost of petrol and oil and vehicle maintenance both increased by 90% while vehicle tax and insurance has increased by 120%. It is noteworthy also that increases in the price of petrol, tax and insurance all began to climb steeply from 2009 onwards.

What this means is that the TOCs have been the beneficiaries of major increases in the costs of motoring – and the measures of the cost of motoring do not include the added costs of parking and the London congestion charge, and cannot take into account the problems of road congestion. All this would encourage switching where the two modes of transport are substitutable. As exhibit 63 shows, the increase in the percentage of journeys undertaken by train almost exactly mirrors the decrease in journeys taken by car since privatisation, with the use of other modes of transport remaining stable over the period.

**Exhibit 63:** Change in passenger transport by mode, annual from 1996<sup>208</sup>



A larger and more detailed research study is required if the aim is to unpack all the drivers of increasing rail passenger numbers since the mid-1980s. Meanwhile, there must be doubts about whether ATOC's members believe the PR claims of their own trade association because their lobbying of the DfT proceeds on quite different assumptions. The link between GDP growth and passenger numbers has been a major issue for all of them since recession pushed several TOCs onto revenue support and caused First Group and National Express to ditch the Greater Western and East Coast franchises. The inclusion of GDP fluctuations in the new franchise revenue share mechanism (described in chapter 5) is the government response, which acknowledges TOC lobbying about the link between GDP growth and passenger numbers.

<sup>208</sup> Source: DfT.

In our view, the paragraphs above present enough argument and evidence to show the absurdity of ATOC's PR narrative – faithfully reproduced by the current government – that increasing numbers of passengers can be attributed to the efforts of our current private train operators. Through good fortune and with massive state subsidy, TOCs have been lucky enough to be positioned in the right place at the right time to cash in, on a boom in rail travel that almost certainly would have taken place anyway.

## Value for money fares

The next issue is about value for money and fare levels. According to ATOC:

*Train operators offer a range of fares that meet different passenger needs, from fully flexible products to those with excellent discounts for travelling at quieter periods. Railcards are also available to many sections of the community and also reduce the cost to passengers, whilst season tickets reduce the cost of buying fares daily by as much as 60%. More than 80% of people travel on some form of discounted ticket. Only 2% of long-distance passengers travel on a full fare ticket. The availability of good value tickets means the UK competes well on price with operators in Western Europe.<sup>209</sup>*

As we have already noted, the overall increases in rail fares have been slower than the costs of motoring. But it is important to bear in mind here that this is not the result of TOC action because some key privatised rail fares (on peak, season tickets, anytime day tickets) have been regulated by government to prevent large above inflation price increases. The fact that, as shown in Exhibit 60 above, rail fares have still risen a great deal in comparison to the RPI, shows that the regulation of some ticket prices has led the TOCs to import airline style practices of 'yield management' which differentiate consumers and charge what various markets will bear.

We can make an across the board comparison of several different kinds of UK fare with mainland European rail fares in the EU's other four largest economies where the rail systems are all state operated. As exhibit 64 shows, price discounts for advance purchase or set times are confusingly variable in different European countries but, averaging across a range of different tickets, UK rail fares are relatively high. For long distance, day return and season tickets, UK prices per kilometre are all around twice as much as the average of France, Germany, Italy and Spain. The UK restricted day return figures are similar to those in Germany, but still significantly more than in France, Italy or Spain; UK long distance advance tickets are the only ones which are as cheap as in several European countries.

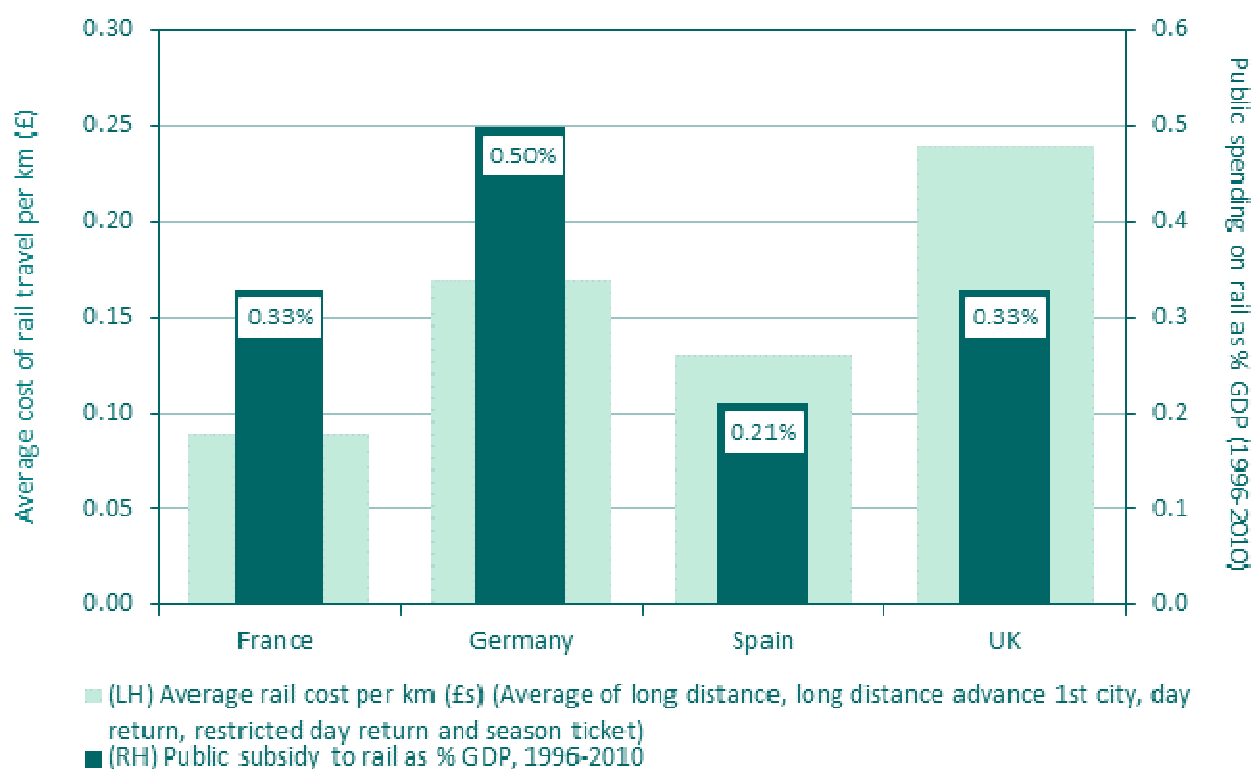
What do we make of these differentials and generally more expensive UK fares? Perhaps these European countries have such dramatically lower rail fares because they subsidise their railways more heavily? While this might be true of Germany, the argument is harder to sustain in the case of France, as shown in exhibit 65 below. In France, a near fully publicly owned rail system manages to give its passengers fares, which are far lower than the UK, for almost exactly the same amount of public rail subsidy between 1996 and 2010.

<sup>209</sup> ATOC, 'Fares on national rail – ATOC's view', available at <http://www.aTOC.org/clientfiles/File/Policydocuments/Fares-2010.pdf>

**Exhibit 64:** Average fare costs in the UK compared with other European countries<sup>210</sup> (£/km)

	Long distance £/KM	Long distance advance £/KM	Day return £/KM	Restricted day return £/KM	Season ticket £/KM
France	0.15	0.06	0.08	0.08	0.08
Germany	0.28	0.13	0.17	0.17	0.08
Italy	0.22	0.10	0.12	0.11	0.04
Spain	0.24	0.16	0.09	0.09	0.07
UK	0.49	0.15	0.26	0.17	0.14

**Exhibit 65:** Public subsidy to rail vs. average cost of rail travel for UK vs. major EU economies<sup>211</sup>



ATOC’s defence of this situation is that the average fare prices hide the bargains, which can be had by the British rail traveller prepared to search around for different fares, saying, ‘it is true that while Britain has some of Europe’s dearer fares, we also have some of the cheapest.’<sup>212</sup> However, as exhibit 64 above shows, even when using advance or restricted tickets (where the passenger gets a

<sup>210</sup> Source: Just Economics.

<sup>211</sup> Source: Just Economics.

<sup>212</sup> ATOC, ‘Fares on national rail – ATOC’s view’, available at <http://www.aTOC.org/clientfiles/File/Policydocuments/Fares-2010.pdf>

cheaper ticket in return for travelling at a specified time), UK costs of travel are still higher than in France and rarely cheaper than in other major European countries.

Besides this, the notion that customers appreciate the hidden bargains and the 'flexibility' of complex ticketing structures is questionable: the flexibility of the ticket pricing means inflexibility for passengers about when they can travel, since they have to specify in advance the exact time of travel and risk paying fines or a new fare if they miss their allocated train. It also introduces anomalies so that, for example, some tickets between two destinations are valid only on one operators' trains; or again, an off peak ticket with a rail card is an anytime ticket on Virgin West Coast but not on other trunk routes. Many passengers would prefer a universally available walk up ticket like the old BR 'cheap day return' from 9.30 am onwards.

Ticket prices have attracted the attention of the rail regulator, whose research has highlighted the extent of the confusion caused by the complex ticketing structures which train operators require for their 'yield management'. In order to meet government targets for average regulated fare prices (on peak) tied to a set rise above the rate of inflation, TOCs have inflated the prices of tickets bought on the day at the station while pulling down advance fares.<sup>213</sup> Research by Passenger Focus reaches broadly similar conclusions on what they call the 'high price of flexibility' reporting that passengers surveyed felt 'forced into paying higher prices'.<sup>214</sup>

The situation is set to get worse following changes to the fares system announced by the government at the end of 2012 and beginning of 2013. The government's new aim is no longer to protect the passenger but to shift the cost of subsidy from government to passengers, because the latter are expected to pay eventually 75% of the cost of rail. As the Campaign for Better Transport argue,

*We do not believe that regulation is proving effective, because it is now being used by the Government with different objectives...It is paradoxical that regulation created to protect the level of fares for certain types of tickets is now being used by the Government to extract more money from passengers, with an expected rise in fares by 24% between 2011 and 2015 as part of an objective to reduce the proportion of rail income from taxpayers to 25% by 2014 ... No equivalent railway in Europe runs on the fare box alone: instead government across Europe invest in public transport because it makes sense for people, the economy and the environment. ... Campaign for Better Transport is very concerned about proposals for 'super-peak' fares. Many passengers have jobs and personal responsibilities that do not allow flexibility. The railway sector has to meet the needs of passengers. The Government should not expect passengers to adapt in order to meet the needs of the railway sector<sup>215</sup>.*

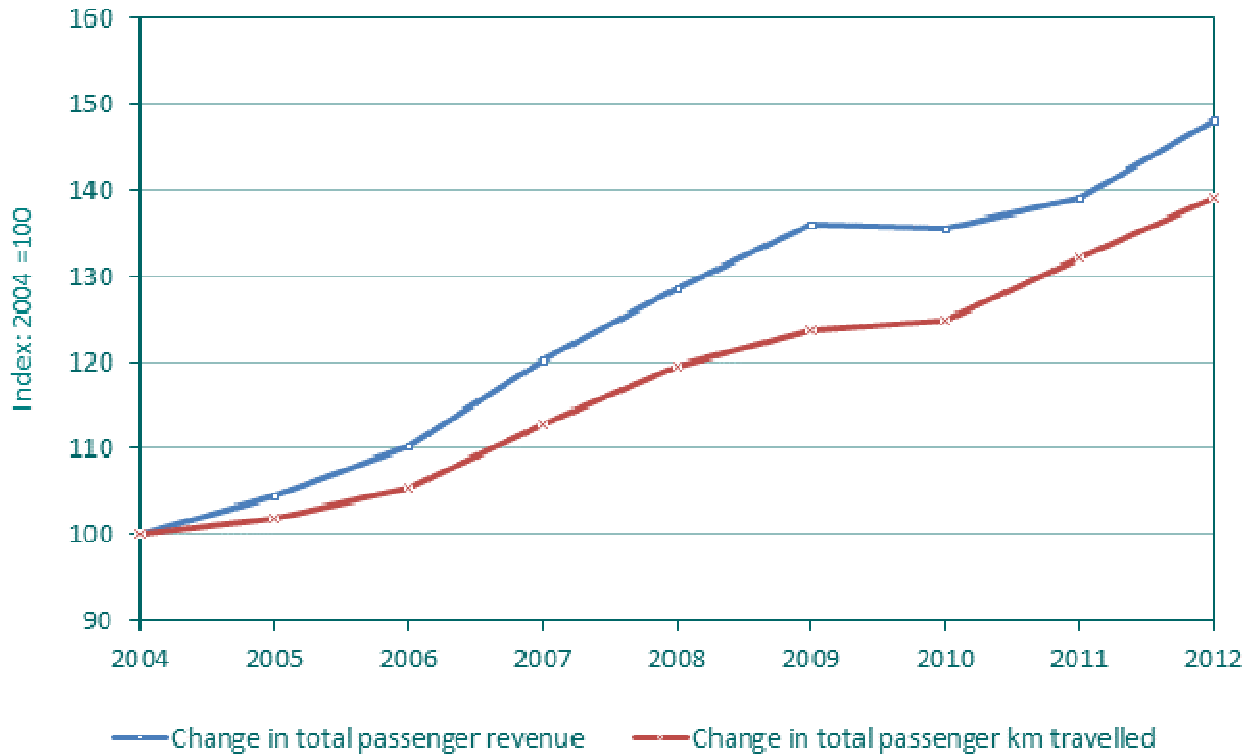
<sup>213</sup> ORR (2012), 'Rail regulator reveals passengers' ticket confusion and calls for improvements'. Available at <http://www.rail-reg.gov.uk/server/show/ConWebDoc.10937>

<sup>214</sup> Passenger focus (2012), 'Passenger Focus response to the Government's rail fares and ticketing review' available at <http://www.passengerfocus.org.uk/research/publications/passenger-focus-response-to-the-governments-rail-fares-and-ticketing-review>

<sup>215</sup> Campaign for Better Transport (2012). *Rail Fares and Ticketing Review Initial Consultation – Response from Campaign for Better Transport*. Available at <http://www.bettertransport.org.uk/files/fares-and-ticketing-review-consultation-response.pdf>

What the TOCs provide when they offer the customer ‘flexibility’ is in fact confusion pricing which, much like Buy One Get One Free deals in supermarkets and TV plus phone product bundles in telecoms, serve to extract more revenue from the customer buying a homogenous product. As exhibit 66 shows, passenger revenue for the TOCs has since the mid-2000s, been rising faster than the increase in km travelled.

**Exhibit 66: Change in passenger revenue, passenger km, and average rail fares<sup>216</sup> (2012 prices)**



## Service quality and satisfied consumers

If the TOCs have ridden the wave of increasing train usage while fully charging their passengers, should we believe their claim that they have improved service quality and satisfied consumers? This issue is important and ATOC can here point to an improvement in recent years in the public performance measure (PPM). This measure was introduced by the Strategic Rail Authority (SRA) in 2000 as a means of gauging the quality of the service provided by the TOCs and its output is one percentage figure which is a combined measure of the punctuality and reliability of the train companies in relation to the timetable (see exhibit 67). The question here is partly about the composite measure and mainly about whether the TOCs can take the credit for any improvement.

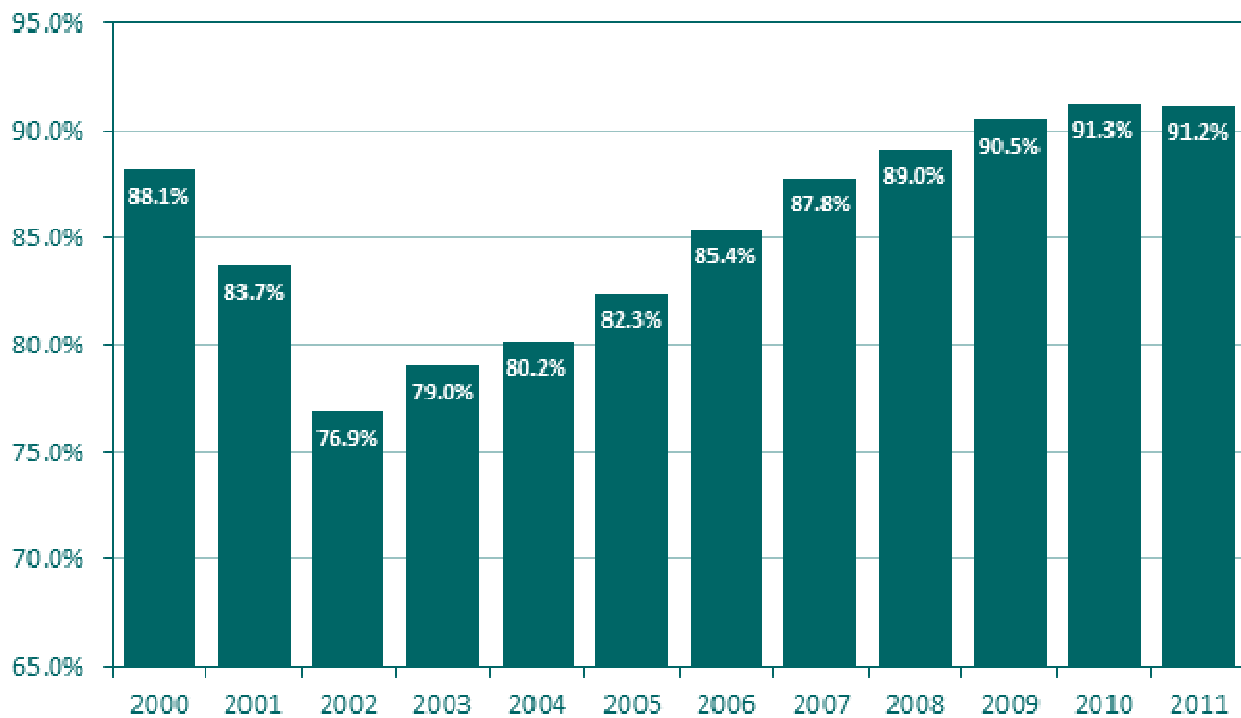
In terms of punctuality, ATOC claims that:

*The train operators have been major players in achieving the improved punctuality that has been achieved. Latest figures available by period show that the delay minutes attributed to*

<sup>216</sup> Source: ORR.

*the train operators were 269,000, 0.9% less than in the previous year and more than 16% better in the last three years.*<sup>217</sup>

**Exhibit 67: Public performance measure (reliability and punctuality)**<sup>218</sup>



However, the question to ask here is how much of this is due to the TOCs and how much is due to Network Rail clearing up the mess left by Railtrack. As exhibit 67 above shows, Railtrack's speed restrictions after the Hatfield rail crash in 2000 led to a collapse in rail punctuality during 2001 and 2002. Leave aside the Hatfield effect, and the improvement in the PPM over the past decade has been modest, from 88% in 2000 to 91% in 2011. Given the significant improvements in digital technology over this period and the massive state investment in infrastructure, it could be argued that similar improvements could have been expected under a state owned system.

Here again the different stories that ATOC and its members tell at various times to the public and the DfT are interestingly not aligned. In the PR narrative above, the TOCs are 'major players' in improving punctuality; but in ATOC lobbying, the crucial importance of infrastructure to punctuality is admitted as ATOC it goes cap in hand to request more support for its members from the state:

*Increasing numbers of trains running and passengers travelling have an effect on punctuality performance, any significant future improvements will need to be linked to increased infrastructure capacity. New lines, which are purpose built with adequate capacity, would produce very high levels of performance.*<sup>219</sup>

<sup>217</sup> ATOC, 'Performance and punctuality – ATOC's view', available at

<http://www.aTOC.org/clientfiles/File/Policydocuments/Performance%20and%20punctuality%20Oct%202010.pdf>

<sup>218</sup> Source: ORR.

<sup>219</sup> *Ibid.*

In the meantime, the ‘the success of train operators in attracting more passengers’ has meant that ‘utilisation of capacity on Britain’s railways is, on many routes, close to its limits’.<sup>220</sup> Furthermore, the costs of the measures necessary to reduce the resulting overcrowding should be charged not to the TOCs but to the state because government must pay for necessary investment in increasing system capacity:

*ATOC welcomes the fact that £35 billion now being spent on Britain's railway infrastructure during the present 2009-14 Control Period (CP4). Nearly a third of which will be invested on projects designed to relieve overcrowding e.g. lengthening platforms and increasing capacity to enable more trains to run.’<sup>221</sup>*

ATOC praises the government’s recent commitment to a major programme of electrification, noting that the UK has one of the lowest levels of electrified route in Europe. It passes over the issue that privatisation was supposed to bring in private investment, but the State is now paying for the first major new electrification scheme since the ECML was electrified under British Rail.<sup>222</sup>

All this is glossed over with puzzlingly vague claims about the scale of ‘private investment’ which ATOC has not been able to clarify for us (nor even reply to emails) despite requests. Thus, ATOC claims that ‘privatisation has been accompanied by the injection of over £30bn in private sector investment, steady improvements in safety, and renewal of rolling stock, so that the fleet is now the youngest in Europe’.<sup>223</sup> Our enquiries did not receive any response after written requests to two separate ATOC staff members for information on the source for their £30bn figure and its components. In the absence of any clarification, our educated guesswork would suggest that around £5bn of this is genuine private investment in rolling stock which comes from the ROSCOs and is guaranteed by the state, with the TOCs paying leasing costs, which they almost certainly would prefer to be lower. The bulk of the supposed £30 billion investment is in infrastructure and so is better considered at best as quasi-private because most of this investment is by Network Rail, the majority of whose funding is either from government grants or from government guaranteed debt. As exhibit 36 in chapter 4 showed, private investment in stations, track and signalling is insignificant compared to the profit taken out of the system by the TOCs.

If the TOCs are not investing in the system, offering cheap fares or driving the increase in passenger numbers, they can with more justification point to high levels of ‘customer satisfaction’. When rail has been refashioned in the imaginary as a form of retail industry driven by competition (not a public service for the common good), the customer’s opinion of the product does become more important. And, as exhibit 68 below shows, quality satisfaction is currently running high as recorded by the independent Passenger Focus organisation so that an average of 85% of customers rate their service as either ‘satisfactory’ or ‘good’ across the major rail franchises This is a solid achievement though the nature of the measure is also important because closer examination shows that it occludes a mix of satisfaction and dissatisfaction with different aspects of the service.

<sup>220</sup> ATOC, ‘Capacity - ATOC’s view’, available at <http://www.aTOC.org/clientfiles/File/capacity2012.pdf>

<sup>221</sup> ATOC, ‘Capacity - ATOC’s view’, available at <http://www.aTOC.org/clientfiles/File/capacity2012.pdf>

<sup>222</sup> ATOC, ‘Electrification – ATOC’s view’, available at <http://www.aTOC.org/clientfiles/File/electrification2012.pdf>

<sup>223</sup> ATOC, ‘Electrification – ATOC’s view’, available at <http://www.aTOC.org/clientfiles/File/Policydocuments/IndustrystructurePrivatisation.pdf>

The Passenger Focus survey derives one measure of overall satisfaction from 31 separate weighted indicators. On the station, the variables include ticket buying facilities; provision of information about train times and platforms; cleanliness of the station; the attitudes and helpfulness of the staff; connections with other forms of public transport; facilities for car parking and how requests to station staff are dealt with and so on. On the trains, variables include the train arriving and departing on time; connections with other train services; value for money of ticket; helpfulness and attitude of staff on train; toilet facilities; sufficient room for all the passengers to sit and so on.<sup>224</sup>

**Exhibit 68:** Passenger Focus: Overall satisfaction with train service, spring 2012<sup>225</sup>

Percentage of customers satisfied	
	%
Arriva Trains Wales	88
C2C	91
Chiltern Railways	90
CrossCountry	84
East Coast	89
East Midlands Trains	87
First Capital Connect	79
First Great Western	82
First Scotrail	89
First TransPennine Express	88
Greater Anglia	73
London Midland	87
Northern Rail	80
Southeastern	81
Southern	80
South West Trains	83
Virgin Trains	91

The composite score is both good overall and hides interestingly uneven results on quality and on price. For example on the key issue of value for money, passengers are not so happy when , as Exhibit 69 shows, more than half of customers on many franchises are not satisfied.

<sup>224</sup> Passenger Focus, 'National Passenger Survey Spring 2012 - Detailed Technical Survey Overview - June 2012'. Available at <http://www.passengerfocus.org.uk/research/publications/national-passenger-survey-spring-2012-detailed-technical-survey-overview-june-2012>

<sup>225</sup> Additional ONS satisfaction data is available here <https://www.gov.uk/government/publications/public-attitudes-towards-train-services>

**Exhibit 69:** Passenger Focus: value for money with train service, spring 2012<sup>226</sup>

Percentage of customers satisfied or good	
	%
Arriva Trains Wales	56
C2C	42
Chiltern Railways	48
CrossCountry	49
East Coast	56
East Midlands Trains	52
First Capital Connect	34
First Great Western	48
First Scotrail	56
First TransPennine Express	30
Greater Anglia	53
London Midland	50
Northern Rail	51
Southeastern	36
Southern	32
South West Trains	38
Virgin Trains	59

Beyond this, although surveys of consumer satisfaction with quality and price of service are relevant, they also frame the problem very narrowly. A respondent to the Passenger Focus survey could give a positive answer to all 31 questions, but still feel deeply dissatisfied with private ownership of the railways. Customer satisfaction surveys and complaints can only say so much since they record individual satisfaction with the service, and not the manner in which it is funded or the social consequences of how it is organised.

The Passenger Focus survey tells us about the opinions of rail service consumers but not of citizens who care about how their taxes are spent on a utility like railways. This is part of a more widespread problem that arises from the current preoccupation with consumerist framing of public choices. For example, customers at Tesco may well be satisfied with the price and quality of the goods they buy from their store, but still be deeply concerned about the impacts of the supermarket retail system on farming and the high street of their town centre. So too, many rail passengers, may have more fundamental concerns about the way the railways are run.

Many passengers do have fundamental citizen concerns if we consider the opinion poll evidence. The significant point here is the high level of public support for renationalisation: 51% support in a 2009 *Politics Home* survey (with a further 18% favouring greater state involvement short of

<sup>226</sup> Additional ONS satisfaction data is available here  
<https://www.gov.uk/government/publications/public-attitudes-towards-train-services>

renationalisation);<sup>227</sup> two thirds of respondents in an October 2012 poll carried out by Vision Critical for the *Daily Express*;<sup>228</sup> 70% of respondents in a GfK NOP poll carried out for Rail Media in September 2012.<sup>229</sup> Opinion poll evidence should be treated with caution because results depend on how issues are framed and questions posed. But a succession of polls indicating widespread support for renationalization suggests that satisfied individual consumers can be and are politically dissatisfied citizens.

## A crucial test: the East Coast main line

The clear public support for rail nationalisation shows that the public is not entirely bamboozled by ATOC's narrative about the many benefits brought by private ownership. But are they now so confused that they may be embracing nationalisation on the basis of 'if not (a) then (b) form of reasoning'? It is therefore very important to note that the East Coast Main line provides us with a test case which allows us to judge whether the private sector profit motive is a necessary precondition of operating efficiency in a train operating company.

Since November 2009, when the franchisee walked away, the East Coast Mainline has been run by state owned Directly Operated Rail. The new team took over after two previous private sector franchises had failed within the space of three years. It began to operate in the middle of a recession, with some of the oldest rolling stock on the network; and ran the line with a hastily assembled team, which had to work without the usual benefit of years of planning prior to a normal franchise takeover. This represented an extreme test since the task of Directly Operated Railways on the East Coast was considerably harder than that faced by most incoming TOCs. Given this, their operating performance is truly remarkable.

- According to the most recent (Spring 2012) Passenger Focus survey, DOR is achieving the joint third highest levels of overall customer satisfaction (as listed in exhibit 67 above), with only Virgin, c2c and Chiltern performing better.
- On the most recent (Q2 2012/13) ORR publication of Public Performance Measures (punctuality and reliability), DOR matches or outperforms all the other InterCity franchises, with a PPM of 89.1 comparing to Virgin's 87.8 for the West Coast, First's 88.7 for Greater Western and Arriva's 89.1 for CrossCountry. Although these margins are slim it should be born in mind that the private sector franchisees have had longer to improve their services.<sup>230</sup> In addition, DOR have managed to pull the PPM up by over 5%, from 84% in 2009 when they took over the route, and all this has been achieved without the £9bn of infrastructure improvements given to the West Coast Mainline and with 20+ year old British Rail electric rolling stock rather than new Pendolinos.

<sup>227</sup> *PoliticsHome*, 'Majority of public support full railway nationalisation' 02/07/2012. Available at [http://www.politicshome.com/uk/majority\\_of\\_public\\_support\\_full\\_railway\\_nationalisation.html](http://www.politicshome.com/uk/majority_of_public_support_full_railway_nationalisation.html)

<sup>228</sup> *Daily Express* 'Poll demands railways must be renationalised' 21/10/2012. Available at <http://www.express.co.uk/posts/view/353370/Poll-demands-railways-must-be-renationalised>

<sup>229</sup> *Rail*, '70% want end to privatisation' 13/09/2012. Available at <http://www.rail.co/2012/09/13/70-want-end-to-rail-privatisation/>

<sup>230</sup> ORR, 'Public performance measure (PPM) by train operating company – table', available at <http://dataportal.orr.gov.uk/displayreport/report/html/255f6c0e-f540-4b44-8686-db16270dde00>

- According to the latest ORR data, DOR raised its timetabled passenger kilometres by 0.18m in the year between Q1 2011/12 and Q1 2012/13, as compared to an average across the 17 franchises of 0.1m.<sup>231</sup>
- According to DOR's 2011/12 annual report, passenger journeys increased by 2% in the latest financial year, providing an increase of turnover of £20m to £665.8m, with an operating profit increase of 7% to £7.1m. This came despite the company serving some of the areas of the UK hardest hit by recession (the North East and Scotland); and despite the disruption caused by (what the company claims was) the largest overhaul of the timetabling for 20 years.<sup>232</sup>

The implication is that profit incentives and private sector management are no magic wand to deliver better train operations. The East Coast case shows that state employed, experienced railway managers without any profit incentive can run an operating company that delivers exemplary efficiency. We agree with ATOC that 'the time for debating the merits of privatisation is passed'<sup>233</sup> but think their preference for the private operator fuses an imaginary about the benefits of private ownership with the self-interest of extractive corporations. At the same time, it would be wrong to make too much of ownership on the railways. In the next chapter we examine the history of the railways, which tells us something about the merits, and demerits of different forms of ownership but also much more about specific unsolved rail sector problems about recovering costs by charging passengers and freight.

## Chapter 7 – (Forgotten) history: recurrent sectoral problems and British Rail's record

### Charge 5: Government has avoided sector specifics by forgetting the pre 1948 history of privately owned railways and by making a straw man out of British Rail

Post 1979 governments have forgotten the pre-1948 history of railways under struggling private ownership, which highlights unsolved sector specific problems; nor have they learnt anything from the British Rail period of public ownership, which is unreasonably ped as awful failure.

The business historians and critical accountants who have studied British railways tell a cautionary academic tale about enduring sector specific problems of cost recovery and discrepancy between low private and high social returns. These expert accounts also tell us about how public ownership after 1948 was undermined by operating losses and under investment which nevertheless finally produced operating efficiency.

<sup>231</sup> ORR (2012), 'National Rail Trends quarterly summary 2012-13 Q1 (1 April to 30 June 2012)', available at <http://www.rail-reg.gov.uk/upload/pdf/quarterly-nrt-report-2012-13-q1.pdf>

<sup>232</sup> Directly Operated Railways, 'Annual Report and Financial Statements For the year ended 31 March 2012' available at <http://www.directlyoperatedrailways.co.uk/PDF/DORReportAccounts2012.pdf>

<sup>233</sup> ATOC, 'Industry structure and privatisation – ATOC's view', available at <http://www.aTOC.org/clientfiles/File/Policydocuments/IndustrystructurePrivatisation.pdf>

It is ironic that social scientists talk so glibly of the knowledge based society and the learning organisation. Milan Kundera, who knew a thing or two about oppressive and stupid political power, was closer to the mark when he implied that power works through forgetting and the erasure of memory. So it is with various official reports on the railways, since the 1992 privatisation White Paper, which contain nothing resembling historical reflection aside from the obligatory lazy caricatures of the failure of state planning and nationalised industries in the post war period.

Consider the most recent and substantial of those reports. The word ‘history’ appears twice in the full-version of the McNulty report, which devotes three of its 320 pages to summarily dismissing the case for any change of industrial structure and ownership:

*The Study is of the view that major cost reductions and value for money improvements can be achieved without sweeping away most of the present structure – this latter course of action would take years to complete, cause major diversion of effort, incur massive costs, and delay progress on improvements that are now being initiated or which could be initiated in the relatively near future.*<sup>234</sup>

Change of ownership is rubbished by citing a cherry-picked selection of secondary sources and adding assertive but unsubstantiated opinion: ‘given the cost reductions seen in other sectors from privatisation, it seems unlikely that renationalisation would lead to a reduction in costs’<sup>235</sup>. This must be so because McNulty believes theologically that excessive government involvement is responsible for many of the remaining high costs of the privatised system.

The evidence and argument of the business and economic historians of British railways since the 1840s provides a counter to McNulty’s assertions; and it is even more valuable because these historians are generally pro-private business, pro-market and pro-mainstream economics. The historians of nineteenth century railways highlight long standing difficulties about cost recovery from passenger and freight revenues and sector specific problems about the widening gap between low and declining private returns and large, diffuse social benefits (despite the historic failure of private companies to deliver an integrated network).

Terry Gourvish’s history of nationalised railways since 1948 is then an especially valuable continuation because it brings out how, despite confused objectives and underinvestment, British Rail delivered considerable operating efficiency by the 1980s. Gourvish’s multi-volume history of British Rail is much cited by critical industry experts; Wolmar takes the 1948-73 volume as a basic source and Roger Ford of *Modern Railways* describes the post 1974 continuation as ‘must read and must have’. It is unreasonably ignored by the political classes whose theological opinions make reading unnecessary.

<sup>234</sup> McNulty *et al.*, *Realising the Potential of GB Rail*, p. 283.

<sup>235</sup> McNulty *et al.*, *Realising the Potential of GB Rail*, p. 285.

## A history of recurrent issues (a) private vs. social returns

The railways have been a fiercely contested political and economic space ever since the initial phase of construction from the 1830s. If we extend our frame of reference backwards, public ownership of the rail system is a vigorously opposed interruption in nearly two centuries of private ownership, which has never resolved sectoral problems but has always generated political lobbying which only adds complications. Over and again, ever since a railway network came into being in the 1840s, we have had recurrence of controversies around the cost of rail to the public and the level of government involvement in the system; plus disputes about the benefits and disadvantages of public and private ownership against a background of lobbying by private companies and their political allies opposed to state intervention.

The first modern railways built in Britain were the result of the spontaneous initiative of industrialists and men of property in the regions. The Liverpool and Manchester railway which opened in 1830 aimed to lower costs of freight transport on monopolistic, slow moving and unreliable canals and incidentally to open new markets for passenger travel. The regular 9.5% dividends which the Liverpool-Manchester venture paid out soon attracted interest from a wider range of investors and the result was a frenzy of railway speculation which lasted until the onset of recession in 1840 and brought into being 65 new railway companies and 2,151 miles of sanctioned track. The boom had taken off again by 1844 with a far greater intensity, resulting by 1850 in the establishment of 755 new companies and 10,091 miles of sanctioned track.<sup>236</sup> At the height of the boom between 1844 and 1851, rail alone utilised 18% of the UK's pig iron output.<sup>237</sup>

This was a form of capitalism, which raised large sums of money to build infrastructure (based on often unreal expectations of profit and plagued by the value skimming of company promoters and such like). Cash surpluses generated by rapid industrial growth needing new outlets and the financial success of early railways attracted industrial, mercantile and *rentier* middle class savings into coupon investment in rail debentures and preference shares. Before the railways boom 5% of national income was invested annually, afterwards it had risen to 10%.<sup>238</sup> Not all the promises to investors were fulfilled, and a Parliamentary Select Committee in 1853 estimated that 2,000 miles of sanctioned track was subsequently not constructed. While some fortunes were made, others lost their savings as some plans failed to generate revenues or even reach construction.<sup>239</sup>

The nation's transport infrastructure had nonetheless been revolutionised within a small space of time, and all without any government assistance in raising capital – something that remained the case until 1914.<sup>240</sup> The enduring legacy was twofold. First, and physically, although Britain mastered the technology of steam railways, the infrastructural result was an imperfectly integrated network because independent company lines served different regions with main lines radiating from various London termini. Second, and financially, railway companies had a huge volume of issued capital so

<sup>236</sup> Bagwell, P.S. (1974), *The Transport Revolution from 1870*. London: William Clows, p. 92-4.

<sup>237</sup> *ibid*, p. 116.

<sup>238</sup> *ibid*, p. 122.

<sup>239</sup> *ibid*, p. 92-4.

<sup>240</sup> *ibid*, p. 99.

that railways in 1870 accounted for almost one quarter of all the securities traded on the London Stock Exchange.<sup>241</sup>

By this date, financial returns were modest. As economic historians have argued – with exceptions and debate over causes and empirics – railways after 1870 were in economic terms an over-capitalised and inefficient industry, weighed down by mis-investment and an inability to control costs.<sup>242</sup> As Gourvish has argued, company boards and senior managers had non-economic objectives.

*Profit maximisation was neither an end for business leaders, nor the only means employed, in the race for prestige, power, status and personal satisfaction. The motives for seeking involvement in railway management included the careerism of executives, the self interest of large shareholder-directors and speculators, and the ambition of those who saw a seat on the board as a stepping stone to political office.*<sup>243</sup>

Within fifty years, the helter-skelter of dynamic railway capitalism reached a very British impasse because social climbers and would be gentlemen had other unproductive games to play on and off the railways. Predictably, this history of dilettante management does not figure in the collective memory of the British elite, which prefers to locate the British cultural problem elsewhere in bolshie workers or reckless bankers.

Historical recurrence is always incomplete because the past is both analogy and disanalogy. In some respects, the corporate bidder for a new TOC franchise is a 21<sup>st</sup> century railway capitalist. But, as we have shown in the preceding chapters, the TOC is a new and different kind of creature which could only exist in the sheltered habitat created by Mrs Thatcher's post-1979 sale of the monopolies. The result is certainly a new kind of mutant senior management in risk-averse corporations, fattened by all manner of public subsidies and fixated upon engineering of a financial and contractual, rather than mechanical variety. Their nineteenth precursors, whether Isambard Kingdom Brunel as heroic engineer, or George Hudson as dishonest company promoter, are very different creatures because they took risks and got railways built.

However, there are important ways in which the specific problems of the 21st century railway sector only rework unresolved issues of the 19<sup>th</sup> century. To begin with, there is a recurrent tension between railway companies and government. Railway companies may not be profit maximising but they are necessarily interested in private returns from investment and on turnover; whereas government is, or should be, concerned with securing social and economic utility from infrastructure. This tension is recurrent and important because, in the nineteenth as in the twenty first century, there is an enduring discrepancy in the rail sector between modest private profits,

<sup>241</sup> Mitchell, B. Chambers, D. and Crafts, N. (2011), 'How good was the profitability of British Railways, 1870-1912?' *Economic History Review* 64(3), p.811.

<sup>242</sup> McCartney, S. and Arnold, A.J. (2003), 'The railway mania of 1845-47: market irrationality or collusive swindle based on accounting distortions?' *Accounting, Auditing and Accountability* 16(5), 821-, Arnold, A.J. and McCartney, S. (2005), 'Rates of return, concentration levels and strategic change in the British railway industry, 1830-1912' *Journal of Transport History*, 26, pp. 41-60. Aldcroft, D.H. (1968) 'The efficiency and enterprise of British railways, 1870-1914', *Explorations in Economic History*, 5, 158-74. ,

<sup>243</sup> Gourvish, T, 'The Performance of British Railway Management After 1860: The Railways of Watkin and Forbes', Volume 20, Issue 2, 1978, pp. 186-200.

which do not capture large and diffuse social returns. Partly, for this reason there is a second recurrent problem about how the absence of co-ordination and integration imposes economic and social costs upon users, which separately makes public ownership and control a perennial issue. In combination, the two problems also ensure that nationalisation is not an easy fix.

This point about low private returns emerges very clearly from a recent and authoritative, quantitative historical study. Mitchell *et al* show that the (private) rate of return on capital for the rail industry fell from 5.6% in the early 1870s to 4.5% in the 1900s. This is higher than estimates of private return in earlier studies but consistent with earlier studies which all concluded that the rail industry persistently and increasingly failed in the later nineteenth century to make the returns expected by investors. But Mitchell *et al* also argue that the social rate of return was much higher so that investment in railways made a positive contribution to socio-economic welfare:

*the consumer surplus gains of transport users, which accrued from cheaper and faster transport than was available from other modes, dwarfed the profits (and even more so the supernormal profits) available to be distributed to the owners of railway companies. So, even though there was indeed waste and inefficiency on the British railways in the late 19<sup>th</sup> century, nevertheless their contribution to economic welfare was massive.*<sup>244</sup>

Interestingly, they also attempt to measure social returns, drawing on Leunig's cost benefit analysis, which implied that the social return from passenger rail moved upwards in the opposite direction to private rail profit rates which were falling in the second half of the nineteenth century. According to Leunig, 'social savings' rose from 3% of GDP in 1870, to 4.4% in 1890 and 6.1% in 1912.<sup>245</sup> Mitchell *et al* then calculate that the social rate of return on the railways rose from 23% in 1870 to 28% in 1890 and 35% in 1912. They conclude that nineteenth century railways were

*... classic examples of a technological innovation whose benefits accrue to consumers rather than proprietors... on average the railways were a great investment from society's point of view, if not for the private investors who financed them.*<sup>246</sup>

Against this background, it is understandable that mid nineteenth century governments felt compelled to intervene to protect and promote the social interest because railways were a vital part of the Victorian foundational economy but the corporate railway-owners were struggling to make a private return and often disinclined to take social objectives seriously.

For a start, railway companies then (as now) were resistant to the idea of democratising railways and encouraging mass usage with low fares. Today's British government does (or should) intervene to restrain the train companies from ramping up ticket prices to unaffordable levels and devoting as much space as possible to the half-empty first class carriages which limit capacity on all our main lines. Governments of the mid-19<sup>th</sup> century had to cajole rail companies into providing services for ordinary workers. Gladstone's 1844 Railways Act starts a push to make rail a means of mass transit,

<sup>244</sup> Mitchell, Chambers and Crafts, p. 830.

<sup>245</sup> Leunig, T. (2006) Time is Money: A Re-Assessment of the Passenger Social Savings from Victorian British Railways, *The Journal of Economic History*, 66(03) in Mitchell, Chambers and Crafts, 2011, 827-8.

<sup>246</sup> Mitchell, Chambers and Crafts, 2011, p. 828.

which was supplemented by reforms requiring the provision of workmen's trains in 1864, and the Cheap Trains Act of 1883.

Passenger journeys subsequently grew from around 50 million per year in the mid-1840s to over 300 million by 1870 and 1100 million by the end of the century. Nearly all of this increase was accounted for by third class passengers, with journeys by first and second-class passengers remaining comparatively stable throughout the period.<sup>247</sup> From the railway company point of view, first and second class fare yield – as we would now say – made this business attractive while third class was a volume market created and imposed on them by government.

## **A history of recurrence (b) network integration and co-ordination**

Network integration and coordination is the other inescapable and recurrent issue, which spurs government intervention. The absence of co-ordination often suits the private interests of local or regional rail companies concerned mainly with point-to-point revenues on radial routes to and from London; but this then imposes social and economic costs upon rail users (including private sector freight users) who want a low cost network and connectivity. These problems start in the nineteenth century and continue in one form or another until the present day. The heroic first phase of railways saw a remarkable growth in terms of track built and companies formed but the benefits subsequently derived by the rest of the private sector were nowhere near as great as they could have been under a more coordinated, planned system.

With the exception of a few larger ventures, the majority of early railway companies were about linking two not so distant points on a map –the average railway company at the height of the boom in 1846 projected a line of just 41 miles. The aim of the game from the viewpoint of the pioneers to build fast and secure a monopoly, with many sections of track built to prevent encroachment by rivals. Arrangements for through traffic were a low priority while there was little standardisation to secure what we would now call interoperability of locomotives and rolling stock.<sup>248</sup> Gladstone's attempts at reform in the 1840s were frustrated by the opposition of the parliamentary friends of the railway companies who opposed more state control.<sup>249</sup> The delays and high costs of transporting goods any serious distance across the fragmented rail system meant that the use of canal barges persisted far longer than might otherwise have been the case. Indeed, despite railway construction from the 1830s onwards, the volume of rail freight did not exceed canal freight until the mid-1850s.<sup>250</sup>

Nineteenth century government thus soon found itself considering interventions to lower the costs of rail freight. Having originally expected that a competitive market for rail freight providers would develop in a similar fashion to the canals and the roads, it soon became clear to politicians that railways tended inevitably towards monopoly: attempts at open track access quickly proved unworkable because it was practically impossible to expect competing lines to be laid side by side,

<sup>247</sup> Bagwell, P. *The Transport Revolution*, p. 109-110.

<sup>248</sup> Bagwell, P. *The Transport Revolution*, p. 172, Wolmar, C (2012), *On the Wrong Line: How Ideology and Incompetence Wrecked Britain's Railways*. London: Kemsing, loc. l179-181.

<sup>249</sup> Bagwell, P. *The Transport Revolution*, p. 172; Wolmar, C. *On the Wrong Line*, loc. l228-30.

<sup>250</sup> Bagwell, P. *The Transport Revolution*, p. 112-3.

and over time the owners of the larger lines sought to buy up smaller rivals.<sup>251</sup> Measures limiting rises in freight charges and passenger fares were levelled with increasing force towards the end of the 19<sup>th</sup> century.<sup>252</sup>

Just as today, the absence of competition on the railways provoked unease amongst nineteenth century economic liberals and, as today, this unease was expressed in a succession of official reports proposing various reforms. The parliamentary friends of the railway companies generally opposed these reports and either ignored or diluted recommendations which did give the impression of something being done by concerned MPs.<sup>253</sup> Just as today, ideology and private sector lobbying had its cost in terms of closed options because even basic and necessary safety regulations were hard to implement. Much as it took the Hatfield disaster to force the issue of Railtrack's loss of control, so it took the death of 78 people in a school excursion train crash in Armagh in June 1889 to force through new safety regulations. On interlocking signals, block working and automatic continuous brakes, the railway companies had previously successfully resisted Board of Trade pressure. Against this background of lobbying, no British government could or would rationalise railways until the First World War left government with no option but to control a system, which would otherwise have hobbled the war effort and military production.

When compared with Continental rail systems, built later and under state control in other major European economies, the British railways system was expensive to construct and use. In 1884, it was estimated that the construction cost of one mile of track was £42,000 per mile in the UK compared with £21,000 per mile in Germany and £28,000 per mile in France. The differential is considerable even allowing for greater availability and the lower price of land in France and Germany. In terms of usage, the cost of freight transport was considerably higher on the more inefficient, haphazard British system created by multiple private enterprises seeking maximum rents from users by 'charging what the traffic would bear'. By way of comparison, the more centrally planned European systems charged lower rates and helped German national industries win against British competition.<sup>254</sup>

After 1918, the British system was neither returned to autarchic local management nor maintained under state control. Instead, Government pursued a middle way of regionalisation under private ownership. Under the Railways Act 1921, the government merged what had been 123 separate companies, into four regional combines in an attempt to limit fragmentation.<sup>255</sup> The system faced growing competition from road vehicles, but benefitted from government support after the 1929 recession and was taken over by government once again with the outbreak of war in 1939.<sup>256</sup> The post-war Labour government did not hand the railways back to private ownership and fulfilled its longstanding commitment to the nationalisation of the industry, integrating the railways – split into

<sup>251</sup> Bagwell, *The Transport Revolution*, p. 170-171, Wolmar, 193-7.

<sup>252</sup> Mitchell, Chambers and Crafts, 'How good was the profitability of British Railways', p. 810.

<sup>253</sup> Bagwell, *The Transport Revolution*, p. 178-9.

<sup>254</sup> *ibid*, p. 99-102.

<sup>255</sup> Gourvish, T. (1990), 'British Rail's 'business led' reorganization, 1977-1990: Government industry relations in Britain's public sector' *Business History Review* 64,, p. 119, Wolmar, 350-2.

<sup>256</sup> Wolmar, *On the Wrong Line*, loc. 413-431.

six regional routes – with other modes of public transport under the British Transport Commission (BTC) in 1948.<sup>257</sup>

### The public ownership experiment: British Rail's record

In railways and other foundational activities, it was not just the left of the Labour party, which favoured public ownership. As Wolmar observes, many industrialists saw public ownership of ill - organised basic industries as a way of reducing costs and improving competitiveness as they argued, in effect, that railways, coal and steel should be treated as public utilities rather than profit making enterprise.<sup>258</sup> The logic of this position was that the primary role of nationalised British Rail (BR) was to produce cheap inputs for the rest of the productive economy and that the effect would most likely be operating losses in a nationalised industry, where profit and loss was not a privileged indicator of performance. The (seldom-stated) implication was that nationalised railway performance should be assessed by some other accounting measures of operating efficiency such as cost per-mile.

The history of British Rail over the next 30 years is a tragedy of confusions about public ownership in a period when (reduction of) operating losses increasingly dominated the public agenda because the political classes could neither accept the economic logic of the utility position nor take the political flak for high prices and restricted services. The post 1992 privatised system has not escaped these confusions partly because, in retrospect, the record of BR is misunderstood through crude stereotypes of failure by politicians and civil servants who have not read and reflected on the careful and thought provoking history of post 1948 railways by Gourvish and others.

The tragedy is that, after the mid-1980s, BR management delivered on operating efficiency which was both its historical justification and a huge practical achievement. As we will argue below, BR management by the 1980s was delivering exemplary operating efficiency (by cost per mile and other indicators against European counterparts) despite being starved of investment. But BR management got very little credit because, by this stage, the BR organisation and the idea of public ownership were thoroughly discredited. BR operating losses were used as a stick to beat the organisation, while dependence on state investment funds led to underinvestment in electrification and modern rolling stock which created an aura of drab out of datedness. This was completely undermining when the Heath and Wilson governments were delivering 'modernisation' and it was widely assumed that cars, buses and trucks would (across much of the network) do to railways what railways had previously done to canals. After 1959, the government was building motorways and go-ahead urban councils like Preston or Swansea were building new town centre bus stations.

As with other nationalised industries, the immediate problem in rail was operating losses charged to the state. Having peaked at £38.7m in 1952, rail operating surpluses vanished and BR's operating deficit had increased to £104m by 1962.<sup>259</sup> Aside from 1951 and 1952, the operating costs of rail were not covered by revenue and generous compensation for the shareholders of the inter-war

<sup>257</sup> Wolmar, C. *On the Wrong Line*, loc. 489-92.

<sup>258</sup> *ibid*, loc. 482-5.

<sup>259</sup> Loft, C. 'Reappraisal and Reshaping: Government and the Railway Problem 1951-64', *Business History*, vol. 15, p. 72-3.

private railway companies made matters worse.<sup>260</sup> Conservative governments of the mid-1950s prevaricated over what to do before a 1955 *Modernisation Plan* from the BTC promised a return to profitability and in 1956 the new transport minister Harold Watkinson pledged to ‘turn the railways away from being just another nationalised industry into an organisation that functions on normal and sensible business lines’<sup>261</sup> – meaning that the railways should work towards the creation of profit rather than public utility. In practise, little was immediately achieved but the next transport minister Ernest Marples set about doing something while establishing a Special Advisory Group (SAG) on the railways, containing Richard Beeching from ICI who headed up the newly formed British Railway’s Board from January 1963,<sup>262</sup> when the Treasury was becoming increasingly intolerant of operating losses. The 1961 White Paper, *The Economic and Financial Obligations of the Nationalised Industries*, introduced the setting of financial targets for state owned enterprises.<sup>263</sup> Within this frame, railways were not a utility providing cheap inputs but an uneconomic industry charging artificial prices, which distorted market demand and capital allocation.<sup>264</sup>

The now infamous Beeching cuts of 1963-5 were a drastic response to these concerns, and proposed that the rail system must be shaped around financial returns rather than social objectives. The initial report produced by Beeching, *The Reshaping of British Railways*, was based around the principle that (aside from urban routes reducing road congestion) only profitable lines should remain open, with bus transport and private car use being more efficient for rural areas.<sup>265</sup> The proposal that followed was for the closure of 2,363 stations and 266 services – roughly one third of the rail network.<sup>266</sup>

The Beeching cuts (which were never fully implemented) had shock value but did not represent a complete break because they accelerated an existing pattern of closures and cut backs in the face of falling rail passenger numbers and rapidly increasing use of private motor vehicles that was established in the 1950s (see exhibit 57). Future transport demand was thought to be for the motor car and the new ‘emergency’ was, as Colin Buchanan argued, how to manage traffic in towns. The logic of rail cuts, which continued under the incoming Wilson government, was of course to reduce the capillary reach of the network and increase the attractiveness of the car as a flexible substitute.<sup>267</sup> This process continued into the 1970s, as cars continued to take a greater share of overall passenger journeys from the railways – the length of motorway doubled between 1967 and 1972, exceeding government targets set in 1960.<sup>268</sup>

Beeching brought new political expectations to railways but BR losses could not easily be eradicated (even after the Beeching closures) and typically increased ominously in every economic downturn

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<sup>260</sup> *ibid*, p. 72-3.

<sup>261</sup> *ibid*, p. 76.

<sup>262</sup> *ibid*, p. 79-82.

<sup>263</sup> Chick, M. (2002), *Industrial Policy in Britain 1945-1951: Economic Planning, Nationalisation and Labour Governments, 1945-51* (Cambridge), 135-137.

<sup>264</sup> Loft, C. ‘Reappraisal and Reshaping: Government and the Railway Problem 1951-64’, *Business History*, vol. 15, p. 86.

<sup>265</sup> *ibid*, p. 85.

<sup>266</sup> *ibid*, pp. 71-92.

<sup>267</sup> Wolmar, C. *On the Wrong Line*, loc. 743-61.

<sup>268</sup> Gourvish, T. (2002), *British Rail: From integration to privatisation, 1974-97*. Oxford University Press, p. 6.

as in the early 1970s. So, the existence of operating losses led to new financial targets and endless internal reorganization often under the aegis of McKinsey consultants.

The 1974 Railways Act, first imposed targets for subsidy to be stabilised and then later reduced them, while restricting external financing and requiring service levels to be maintained.<sup>269</sup> A further white paper on the Nationalised Industries in 1978 paved the way for stricter financial targets and more complex performance indicators, producing what Peter Parker, then British Rail chairman described as a state of ‘perpetual audit’.<sup>270</sup> Tinkering with the organisational structure of BR in the late 1970s was a substitute for thought insofar as it covered what the historian Gourvish has described as,

*deep-seated confusion about what the railways were actually supposed to achieve in a mixed economy ... from the beginning the politicians attempted to produce an entity which could combine public service aspirations and commercial viability, but after 25 years’ experience this search was something of a Holy Grail.*<sup>271</sup>

The election of the Thatcher government in 1979 opened the way to a questioning of public ownership, which in due course made rail privatisation possible. But, immediately, the Thatcher government in the rail sector just intensified the pressure for profits through reorganisation. In 1982 BR’s four level structure of board, region (London Midland, Eastern, Western, Southern, Scottish) division and area was scrapped, BR was then split into five separate profit centres – three passenger services, Intercity, Network South East and Provincial, and then freight and parcels. Peripheral aspects of the organisation, such as hotels and catering, were privatised.<sup>272</sup> The thrust of the reforms was to make BR more ‘business led’ in a management accounting sense, so that costs and revenues could be allocated to the different business profit centres, thus making it easier to limit government expense on unprofitable services.<sup>273</sup> As Gourvish has argued, many of these changes stemmed from internal discussions within the BR Board, in the context of pressure from government to reduce the financial burden of the railways.

Government pressure increased as operating losses at BR rose dramatically during the 1980s recession: targets for reductions in subsidy amounted in real terms to a 25% cut between 1983 and 1986.<sup>274</sup> In these financial circumstances and with rail passenger numbers at historic lows, the government-commissioned Serpell Report of 1983 floated Beeching-like options for further drastic downsizing of the railway network to remove unprofitable services.<sup>275</sup> These cut backs were never implemented and instead, under testing conditions of financial constraint and constant scrutiny BR’s performance improved cyclically in a way which also marked the beginning of new secular trends and an end to the decline in headline passenger numbers (as illustrated in chapter 6).

<sup>269</sup> Gourvish, T. ‘British Rail’s ‘business led’ reorganization’, p. 1990, 120-121.

<sup>270</sup> Quoted in Gourvish, T. *British Rail: From integration to privatisation*, p. 44.

<sup>271</sup> Gourvish, T. *British Rail: From integration to privatisation*, p.2.

<sup>272</sup> Gourvish, T. (1990), British Rail’s ‘business led’ organization, 1977-1990: Government industry relations in Britain’s public sector *Business History Review* 64, 109-49.

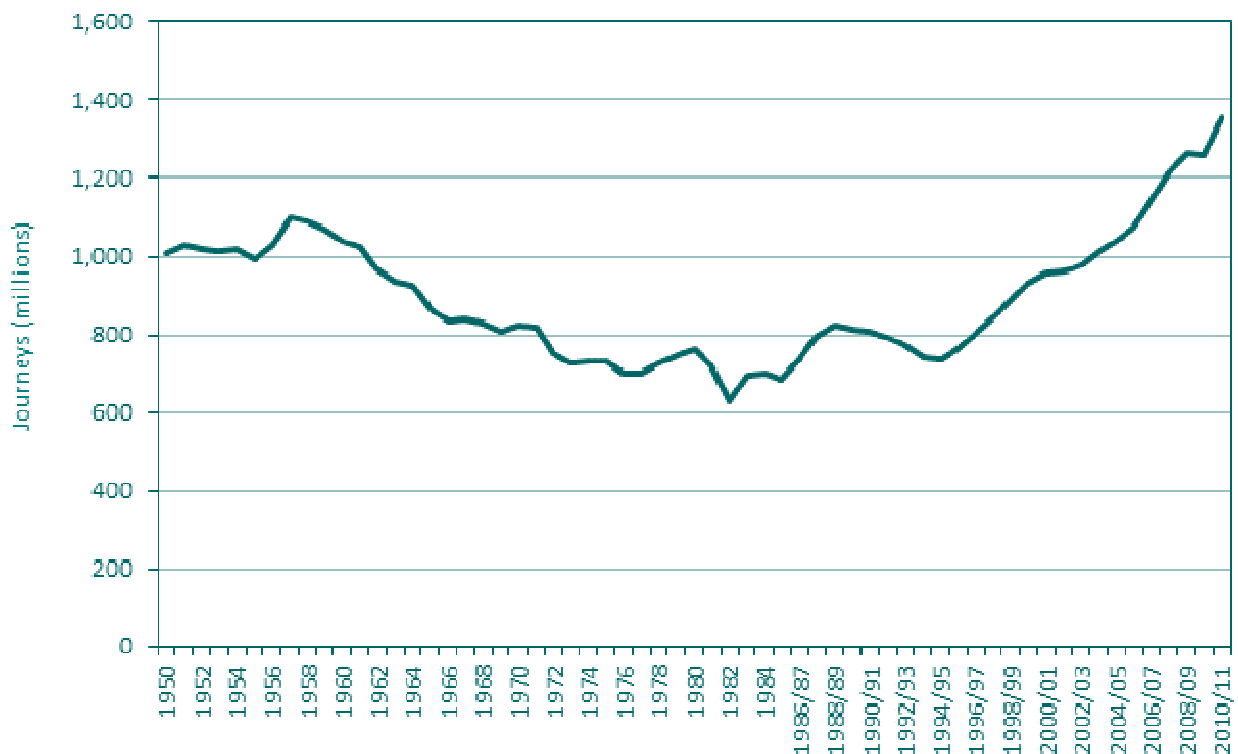
<sup>273</sup> *ibid*, p. 118.

<sup>274</sup> *ibid*, p. 122.

<sup>275</sup> [http://www.railwaysarchive.co.uk/documents/DoT\\_Serpell001.pdf](http://www.railwaysarchive.co.uk/documents/DoT_Serpell001.pdf)

With strong economic growth, all three passenger businesses increased their incomes, with an aggregate growth in real passenger income of 36% between 1983 and 1989.<sup>276</sup> As passenger traffic went up from 18.4 to 21.3 billion passenger miles, so group profit (in 1982 prices) increased from £63.8m to £225.8m, and the subsidy from government fell from £933.4m to £475.5m. As exhibit 70 shows, in terms of increases in passenger numbers this remarkable shift also marked new secular trends and the beginning of the railway renaissance in the UK. However, the dip in the mid-1990s also showed that railways remains a markedly cyclical business with semi fixed costs and volatile revenue. As with the privatised rail system that came later, demand for rail travel was significantly affected by economic growth.

**Exhibit 70:** Passenger journeys by train, annual from 1950<sup>277</sup> (millions)



By the early 1990s when the idea of rail privatisation began to gain traction, the legacy of 40 years of public ownership, confusion and endless pressure on BR was paradoxical. Under pressure to control losses and limit public subsidy, the network had been starved of investment but the BR organisation had become extremely efficient at controlling costs. The margin of superiority varied cyclically and was probably improving in secular terms. BR in 1989 was 40% more efficient than eight comparable rail systems in Europe used as benchmarks, whereas in 1979, BR was no more than 14% more efficient.<sup>278</sup> Nonetheless, the legacy of underinvestment and well-publicised operating losses meant that BR and railways were in low public esteem and there was certainly customer dissatisfaction with the service quality.<sup>279</sup>

<sup>276</sup> Gourvish, T. 'British Rail's 'business led' reorganization', p. 130.

<sup>277</sup> Source: DfT.

<sup>278</sup> *ibid*, p. 149.

<sup>279</sup> Wolmar, C. *On the Wrong Line*, loc. 894-911.

In the rush to implement privatisation before the end of the Major government, the political classes did not register that although the rail sector might not have been in cyclical crisis at that time, there were long term secular problems about cost recovery from fares in the rail sector. Nor did the discussion consider the power of economic cyclical, which had been demonstrated at least three times in the past twenty years. Instead, as we have noted, politicians put their trust in the generic transformative character of private enterprise and naively assumed that private capital would rush in to an industry where there was no prospect of sustained returns. This set of assumptions was then maintained despite the fact that historians had identified these problems very clearly. Moreover, radical accountants, such as Jean Shaoul, would predict the failure of a privatisation programme that ignored the

*particular circumstances of a capital intensive industry such as the railways. The source of the problem was not simply competition, regulation or its lack, but more importantly the insufficient surplus created by the industry relative to the amount of capital invested in the industry, to meet all the claims consequent upon privatization.*<sup>280</sup>

The outcome was thus a serial shambles where the long-term problem of cost recovery was palmed off onto the state, while private corporates positioned themselves for value extraction around leasing and franchising. We have paid a high price for the way in which our political classes and civil servants have ignored the history of rail sector specifics.

## Chapter 8: Policy reviews become part of the problem

### Charge 6: Business led policy reviews and the official mentality are part of the problem not the solution

Government is part of the problem because policy since rail privatisation is hurried improvisation and hyperactive reorganisation, which masquerades as rational reform while it delivers the next instalment of serial shambles.

So it is with the current regime change where a 2012 White Paper builds on the framing and recommendations of McNulty's business led policy review. But, realigned incentives around new metrics for super TOCs and the break-up of Network Rail are very unlikely to deliver the projected efficiency savings.

Central government has become part of the problem not the solution since rail privatisation because successive governments over twenty years have been unable to manage or control the dysfunctional consequences of the rail privatisation which John Major's government initiated. This is mostly because they assimilate (or cannot challenge) business based definitions of reality which are promoted by the TOCs, as through the McNulty review of *Rail Value for Money*, which is the basis for the current round of reforms.

<sup>280</sup> Shaoul, J. 'Leasing passenger trains', p.211.

McNulty's review is important as a framing device. This review sets up centralised Network Rail and interfering government as the villains. It then makes recommendations which encourage government to back out and break up Network Rail, while the TOCs become what we will call 'super TOCs' which gain through longer franchises and regional reintegration of trains and track. This agenda is then adopted in the DfT White Paper of 2012, which implements key McNulty recommendations: specifically, the DfT gives the hitherto ineffectual rail regulator a much larger role and thereby further removes railways from democratic accountability and political control.

The current reforms as proposed in 2011-12 amount to a regime change for rail which (as so many times before) promises to deliver increased customer satisfaction and dramatic cost reduction. Our critique of current reforms in the last section of this chapter explains why disappointment is the most likely outcome. Regional reintegration of train and track using a variety of untried models will increase complexity and multiply perverse consequences and the most probable outcome is that it will increase corporate opportunities for extracting returns with limited risk.

All this is deeply ironic. As we have seen, privatisation was floated on hopes about the generic character of transformative private enterprise; the importance of specifics is now recognised by McNulty and the DfT who see that 'one size does not fit all'. But specifics are now to be engaged on terms which suit the entrenched private interests of aggrandized TOCs, and the end result will be another instalment of serial shambles with the further fragmentation of the network around a new set of contradictions.

### McNulty's problem definition

The British political and business elite cannot deny the problems of the railway sector, but they do frame those problems very differently from the way we have done in previous chapters of this report. The basis for the present round of reforms to the railway is the 2009 - 2011 *Rail Value for Money* study chaired by Sir Roy McNulty, who earned his knighthood after passing several times through the revolving door between the civil service and the para-statal private sector before authoring a report on the rail sector which endorses the TOCs point of view.

McNulty identified a total of ten 'barriers to efficiency'. If we wish to understand McNulty's conceptual framing of the problem, the ten barriers can be grouped under three headings because the issues are all about fragmentation, mis-incentives and interference, which combine to make the railways bad value for money.

- i. **A fragmented culture**, or as it is termed in the report, a 'co-operation deficit' and a 'lack of leadership':

*Having multiple industry players, together with misaligned incentives and the existing railway culture, has made it difficult to secure co-operative effort at operational interfaces, or active industry engagement in cross-industry activities, which need to be undertaken for the common good.*<sup>281</sup>

The report recognises that each company in the rail industry attempts to maximise their position within a silo rather than 'optimising outcomes for the customer or for the industry

<sup>281</sup> (2011) *Realising the potential of GB rail: summary report*, p. 36.

as a whole'. This means adopting an uncooperative and non-transparent approach to their activities, which manifests, for example, in unpredictable demand for rolling stock, a pervasive lack of collaboration, and a general lack of integrated 'whole-system' planning.

- ii. **The wrong incentives:** Network Rail is presented as too large, complex and centralised. In the absence of competitive pressure, Network Rail has an 'arrogant' culture towards its customers – the TOCs – and limited incentive to grow traffic volume. The TOCs for their part are judged to be allowing 'commercial interests ... to stand in the way of co-operation', exhibiting an 'unhelpful degree of 'short-termism' in an industry that requires long-term planning for its proper development', and paying inadequate attention to reducing Network Rail's or the ROSCOs' costs. This behaviour is facilitated by their insulation from changes in track access charges and associated costs because Network Rail and the ROSCOs are responsible for infrastructure and vehicles.<sup>282</sup> Overall, the report says, 'the direct interplay between costs and revenue, which normally helps to drive business-like decisions, is severely impeded'.<sup>283</sup>
- iii. **Government interference:** the high-level of government involvement in the industry via the DfT and ORR, responsible for setting performance criteria and franchise specifications, is judged to have reduced commercial pressure on industry to make cost reductions. The over-centralisation of decision making is said to have resulted in a lack of clarity and coherence in policy making which further discourages industry-led investment and service improvement.<sup>284</sup> TOCs, the report says, are not helped by franchises which are said to be both too short (providing another incentive against investment) and too prescriptive. In addition, McNulty points to an overly complex legal and contractual framework, which increases costs and enables gaming of the system.

As McNulty admits, his analysis is not entirely original. Many of these problems of fragmentation and misaligned incentives were identified in the 2004 White Paper *The Future of Rail*.<sup>285</sup> But the more radical reform proposals of 2004 were not acted upon by a New Labour government whose reforming impetus was exhausted by the process of turning the failed Railtrack into the phoenix-like Network Rail.

McNulty's problem definition is nevertheless important because it sets up the idea that the two sources of the railway's problems are over centralised Network Rail and interfering government. The TOCs are of course criticised, but their faults are the result of misincentives in the system and they should not be marginalised but put at the centre of things after reform; whereas, Network Rail and government need to do things very differently and either break up or back out. For McNulty, the TOCs are victims of circumstance which could, with reformed incentives, become the heroes of the next act.

<sup>282</sup> *ibid.*

<sup>283</sup> *ibid*, p. 37.

<sup>284</sup> *ibid*, p. 37.

<sup>285</sup> [http://www.southwest-ra.gov.uk/media/SWRA/RSS%20Documents/Technical%20Documents/02.12\\_DfT\\_-\\_the\\_Future\\_of\\_Rail\\_-\\_July\\_2004.pdf](http://www.southwest-ra.gov.uk/media/SWRA/RSS%20Documents/Technical%20Documents/02.12_DfT_-_the_Future_of_Rail_-_July_2004.pdf)

## McNulty's reform agenda

The point of departure for McNulty is not Christian Wolmar's fundamental question: what are the railways for and whose interests do they serve. Instead, McNulty, like Coalition transport ministers and their New Labour predecessors, starts from the optimistic theological assumption of original virtue, and the supposition that the right (privatised) system is being run in the wrong way. Whatever the problems with railways in the 2000s, McNulty believes privatisation is an inherently superior system with franchising at its heart; logically, therefore, a structural move away from franchising is unthinkable and (quite remarkably) the TOCs are to be given an enlarged role at the expense of a much diminished Network Rail in a system with less government interference.

The *Rail Value for Money* review was contradictory and confusing on change. The report's declared aim was to avoid structural change:

*as far as possible, to adapt existing structures rather than to sweep them away, and to focus the efforts of all concerned primarily on the areas where efficiency can be improved rather than on total reorganisation.*<sup>286</sup>

But its recommendations promised 'major change' in terms of financial results with the aim of securing a 30% improvement in efficiency which would deliver a £3.5 billion cost saving by the end of Control Period 5 in 2019.<sup>287</sup> The means was a bewildering set of more than 50 separate recommendations whose declared aim was reform of incentives to make the franchise system operate more effectively. Incidentally, this would mean one major structural change because the McNulty recommendations implied the end of Network Rail as we know it.

Within McNulty's frame, government should have a limited role in a railways sector, which was properly driven by 'commercial objectives'. His report accepted that the government would continue to lay down what the industry should deliver – as under the 2005 Railways Act with the secretary of state responsible for specifying the outputs and performance metrics of the industry during five year 'control periods'. But government should not then interfere in how this is delivered by the private sector (above and beyond installing a regulator, the ORR). In McNulty's view, 'individual companies will naturally pursue their own commercial objectives' and the responsibility of government is therefore to reform the contractual frameworks and align incentives in order to channel their animal spirits towards socially useful ends.

First, McNulty recommends (and the DfT is now implementing) a reform of franchising which would make contracts longer and looser, giving the operator greater freedom of movement in which to 'innovate' and invest. The report complains that 'the high degree of Government involvement has led to too many decisions being made remotely from the market' and the expectation going forward is that 'the rail industry needs to be given, and needs to accept, greater responsibility for its own future'. Longer franchises are to be supported by a Rail Delivery Group, comprised of chief executives from the TOCs and the freight owning companies, plus Network Rail, who will come together to provide 'cross-industry leadership' for cost reduction while 'encouraging a change of culture within GB rail – towards partnership, openness and continuous improvement.'

<sup>286</sup> (2011) *Realising the potential of GB rail: summary report*, p. 46.

<sup>287</sup> *ibid*, p. 26.

Secondly, and in his most significant recommendation, McNulty proposes that government should force the break-up of Network Rail's national organisation and instead promote devolution and regional integration of infrastructure with TOCs in the different franchise areas. This break-up of what McNulty considers to be an overly centralised and unresponsive Network Rail would allow decisions to be taken 'at the levels within the industry which are closest to the market' while aligning incentives between Network Rail and the TOCs.

The reports states that 'there must be recognition that 'one size does not fit all'' and the integration between Network Rail and the TOCs could take several different forms. At a minimum, it could involve cost and revenue sharing combined with joint targets; and, at a maximum, the result would be full vertical integration with a combined concession of infrastructure management and train operations. Whichever structure is applied – under the criteria of 'best value for money' – the report considers it 'vitally important that the infrastructure managers ... and the train operators have a commercial interest in each other's cost and revenues'. Devolution of this kind would allow 'the comparative regulation of route performance in both financial and operational contexts'.

On the assumption that 'there is no reason why all of the devolved infrastructure managers need to be controlled by a single company', ownership and management of the different sections of infrastructure would under this plan in due course be passed to different companies in order to 'strengthen competitive pressure' around efficiency benchmarks. While Network Rail would retain some central management roles to make sure the network remained seamless, it would survive essentially as a holding company, perhaps without a government Network Grant. McNulty believed that, if Network Rail obtained all its income from TOC access charges and its property portfolio, this would further align interests and increase transparency.

The McNulty report suggests that this devolution could take place initially on 12 routes, comprising an existing nine franchises plus Merseyside, Wales and, via a re-drawing of the franchise map, a Northern Region. Local authorities or Passenger Transport Executives would be given the opportunity to influence outputs (though the exact means remain only vaguely specified).

In terms of incentives, McNulty proposes putting greater contractual pressure on the TOCs and ROSCOs to reduce costs by, for example, making franchise awards dependent on not only premium profiles but also unit cost reduction profiles, and by giving the ORR the power to undertake periodic reviews of franchise commitments alongside benchmarking of their costs. This would be part of a third significant thrust of reform because McNulty envisaged a much larger role for the ORR in a reformed system. The ORR – currently responsible for Network Rail, while the DfT manages franchises – would have overall responsibility for monitoring the costs and revenues of all aspects of the railway system.

McNulty also suggests additional measures to ensure cost reduction in different spheres. There should be greater clarity about projected demand and procurement strategy, which, along with early involvement of suppliers in the procurement process, would reduce supply chain costs. Operating costs could be reduced by sacking staff and cutting salaries (presented rather obliquely

as ‘significant changes for the people in the rail industry’). The rail unions estimated that some 20,000 jobs were at risk in relation to the McNulty report.<sup>288</sup>

### DfT’s political adoption of McNulty

The DfT’s response to McNulty’s 2011 report was the March 2012 White Paper *Reforming our Railways: Putting the customer first*.<sup>289</sup> This shared McNulty’s assumption that policy must be directed towards ‘promoting and protecting the achievements of recent years’ and that this was best done by maintaining a franchise based system (and incidentally restructuring Network Rail).

In terms of position, frameworking and even form of words, large parts of the two documents are interchangeable. Here, for example, is the white paper defending the franchise system from structural reform in terms that echo McNulty’s defence of franchising and what TOC chief executives have been saying:

*The rail industry is not broken. The case for a further round of major structural change, impacting safety, performance and cost as the industry struggles to adjust, has not been made.*<sup>290</sup>

Specifically, the DfT white paper proposed seven measures for reforming the franchise system:

- iv. Longer franchises
- v. Greater flexibility for the TOCs in service configuration
- vi. Outcome based requirements for the TOCs, centred on passenger satisfaction
- vii. Less government intrusion
- viii. Transfer of functions from DfT to Office of Rail Regulation
- ix. Better profit sharing mechanisms to protect the taxpayer
- x. Alignment of incentives between TOCs and Network Rail (via alliances initially, then concessions and vertical integration)

The DfT paper could be fairly represented as McNulty with added political spin. To begin with, the White Paper is rhetorical because it aligns its railway recommendations with the more general tropes of Coalition political reform. It insists the aim of railway reform is ‘placing the passenger back at the heart of everything the rail network is about’<sup>291</sup> and any broader notion of the public interest vanishes. Longer and more flexible franchises are politically congenial partly because they would be in line with the Coalition’s cross-departmental ‘Red Tape Challenge’. At present, the franchise system is ‘overly bureaucratic’,<sup>292</sup> meaning that companies direct their contract management toward hitting arbitrary targets rather than making productive investments or satisfying passengers. Bureaucracy is of course a wholly negative burden with no recognition of the positive political role of an independent civil service

<sup>288</sup> See the rail unions’ joint submission to the Transport Select Committee’s *Rail 2020* inquiry. Written evidence from the TUC, ASLEF, RMT, TSSA and Unite (ROR 24), 18th April 2012. Published in the House of Commons Transport Committee 7th Report Rail 2020, 17th December 2012. Available at: <http://www.publications.parliament.uk/pa/cm201213/cmselect/cmtran/329/329we16.htm>

<sup>289</sup> Department for Transport, March 2012, CM 8313, The Stationery Office

<sup>290</sup> CM 8313, p.8.

<sup>291</sup> CM 8313, p.6.

<sup>292</sup> CM 8313, p.25.

Much of this spin is vacuous. Thus, (of course) the recommendation for devolution and a more regionalised railway system is connected with the government's localism agenda. The White Paper claims a reform of franchising will give 'local, democratically accountable bodies a greater say over local services, allowing a stronger input from local passengers than may occur with central and more remote decision-making.'<sup>293</sup> This means very little because, with the exception of Wales and Scotland (and London overground), the railway franchises will not coincide with existing local government boundaries or fit with regional government institutions (that in any case do not exist in England). Any involvement via local government would most likely simply be via piecemeal inclusion of some representatives on the boards of a complex franchising project.

If the White Paper is rhetorical, it is also radical because, on government interference, it goes well beyond McNulty. The DfT has radical plans to distance railway decision making and accountability from ministerial responsibility and democratic control. A cynic would argue that the White Paper is about central government ducking out of its management and strategic responsibilities for a national infrastructural system. The government of course represents the process as a more rational one of returning decision making to its proper locus and introducing new independent safeguards.

Thus, the Rail Delivery Group (as originally proposed by McNulty) was set up in May 2011 and has since been working to establish a 'culture of partnership'. The DfT views the Group very positively because this is an opportunity 'for Government to return key roles and responsibilities to the rail industry.'<sup>294</sup> Moreover, the RDG has been given responsibilities that include developing strategies and plans for rail, implying a potentially significant shift of the management of the agenda to the industry.

The DfT's 2012 White Paper is most radical when it proposes a greatly expanded remit for the Rail Regulator.<sup>295</sup> The DfT's reasoning on this point is explicit and fairly predictable:

*Over time, our ambition is to progressively move the ORR to the heart of whole industry efficiency and performance, taking Government out of day-to-day industry business.*<sup>296</sup>

Within the standard frame, there has to be continued ministerial responsibility over 'setting a top-level strategic direction for rail and for the use of public funds'<sup>297</sup>. Beyond that, the 2012 White Paper now proposes an expert governance model for the railways which would be like that of other privatised utilities such as gas or water. Here an independent regulator, like Ofcom, Ofwat or Ofgem is insulated from democratic pressures and given a leading role in setting policy and challenging an industry, which then sorts out operating matters for itself.

The DfT represents this as a tough new governance regime because the White Paper envisages that the ORR as an independent regulator will be 'driving relentlessly for efficiencies' and will be 'tough

<sup>293</sup> CM 8313, p.24.

<sup>294</sup> CM 8313, p.39.

<sup>295</sup> This was discussed further in the government's 2011 consultation document [http://www.rail-reg.gov.uk/upload/pdf/regulator\\_role\\_consultation\\_dec2011.pdf](http://www.rail-reg.gov.uk/upload/pdf/regulator_role_consultation_dec2011.pdf), with conclusion from the ORR forthcoming.

<sup>296</sup> CM 8313, p.26.

<sup>297</sup> CM 8313, p.29.

on train operators that abuse their market position or indulge in anti-consumer behaviour'.<sup>298</sup> We rather doubt whether the TOCs have much to fear for several reasons.

- First, the ORR has no record of tough action or indeed effective protest against value extraction against TOCs and ROSCOs. We are now asked to believe it will behave differently and more effectively against the more powerful regional monopolies that would be created by the integration of Network Rail and the TOCs.
- Second, the mission of policing 'anti-consumer behaviour' is a regulatory distraction because, in the absence of any competition on the railways, it is not possible to apply standard micro economic analysis as to whether the charging of costs is fair. The result is likely to be endless confusing and indecisive reports about train timekeeping and fare structures.
- Third, regulators work most effectively where there is a homogeneous product supplied by firms whose return on capital employed (ROCE) can be meaningfully calculated on the basis of a market derived margin between firm costs and customer revenues. However, these conditions do not apply in railways, which have long standing sectoral problems about cost recovery, and where the TOCs are fee for service SPVs operating in a space of politically constructed profit.

These points imply that, at the very least, the regulator's new task is going to be politically and technically difficult. But the more fundamental question is about serial shambles: is the ORR in 2012 being brought in to patch over insoluble contradictions (in much the same way as Network Rail was brought in a decade earlier)? The White Paper proposal for a greatly enlarged role for the regulator is certainly an absolutely classic example of the continued power of generic thinking because there is no recognition of the rail sector specific problems created by the long standing problems of cost recovery and revenue constraint in the industry. And only a half-hearted recognition of how the state absorbs and guarantees losses while TOC actors game the system.

It would have been much better if the authors of the DfT White Paper had not relied so closely on McNulty's report but read and pondered Gourvish's (2002) history of British Rail's nationalised operating efficiency or Shaoul's (2007, 2011) accounting articles on the revenue constraint in privatised railways with 'insufficient surplus... to meet all the claims consequent upon privatization.' Because of serial shambles, Shaoul's point is more relevant than ever in 2012. As we argued in chapter 4, the collapse of Railtrack extinguished one set of shareholder claims at the price of creating new and expanding bondholder claims in Network Rail. If we set this in the context of our earlier argument about lower track access charges and back-loaded franchise bids, after 2002 the sector's problems about cost recovery and inadequate passenger revenues were under Network Rail dealt with by charging them to the state while the TOCs gamed the system in their world of politically constructed profit.

But, even more so than T S Eliot's humankind, our political classes "cannot bear very much reality". The serial shambles cannot be acknowledged so that it becomes the basis of radical policy geared to sector specifics. Because the admission of subsidy shuffling and risk passing would raise very difficult questions about what successive governments have done since 1993 and because 'game

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<sup>298</sup> CM 8313, p.25.

over' radical reform would grossly offend the private interests who were conciliated by the TOC friendly McNulty report.

The DfT continues with the principle of not offending any entrenched private interest in the system. Thus, the White Paper not only conciliates the TOCs by offering them a larger role but also pleases the ROSCOs by offering them a continued, untroubled life. A 2010 Competition Commission report criticised limited competition<sup>299</sup> in train leasing which is considered to be a problem by the DfT. But ROSCOs now get off remarkably lightly and train leasing is subject to less reform than the franchise system.<sup>300</sup> The DfT simply assumes that longer and more flexible franchises will provide greater incentives for rolling stock investment, and that proposals from the Association of Train Operating Companies (ATOC) to create an industry wide rolling stock plan will improve the supply chain inefficiencies born out of unpredictable 'feast or famine' ordering patterns.<sup>301</sup>

But, if much is accepted and unreformed, the shambles cannot be entirely denied and something has to be done. So, the DfT White Paper does a kind of two-step, which firstly recognises problems and then secondly calibrates the problems as manageable. Thus, the White Paper admits problems about the gaming of franchising bids and afterwards about poor operating decisions but supposes these problems are manageable because the TOCs are originally virtuous and consequently any problems about their current behaviour can be sorted out by rewriting contracts with different incentives.

Thus, the DfT accepts that TOCs do not always put the passenger first:

*Anecdotal evidence also suggests that it has sometimes been too easy for operators to benefit from the engineering work and performance compensation regimes rather than serving passengers effectively.*<sup>302</sup>

Nonetheless, the DfT's approach with longer franchises will be to 'treat operators as mature companies with a vested interest in satisfying their passengers'.<sup>303</sup> Because original virtue means the TOCs will serve the customer if they can, and this optimism colours the DfT's attitude towards bid gaming which can be managed by re-jigging incentives.

Thus, the 2012 White Paper recognises bid gaming, albeit in understated civil service prose: risk sharing mechanisms under present franchises have 'insulated prospective franchisees from the consequences of overambitious bids and unrealistic revenue growth forecasts' and this problem could be exacerbated by longer franchises.<sup>304</sup> But the gaming of bids is a technically manageable problem, which can be controlled by developing a more elaborate set of risk-sharing mechanisms, such as premia payments index-linked to GDP or urban employment, or selecting franchisees based on proven records of cost reduction.

<sup>299</sup> [http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/non-inquiry/rep\\_pub/reports/2009/fulltext/546](http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/non-inquiry/rep_pub/reports/2009/fulltext/546)

<sup>300</sup> CM 8313, p.56.

<sup>301</sup> CM 8313, pp.57-8.

<sup>302</sup> CM 8313, p.33.

<sup>303</sup> CM8313, p.33.

<sup>304</sup> CM 8313, p.46.

The message of the White Paper is that all things are possible with appropriate incentives. If the train companies have 'clear objectives and aligned incentives' which encourage an 'aggressive' pursuit of cost reducing efficiency, the rail sector can achieve 'world beating excellence' and the DfT's aim is to eliminate McNulty's £3.5bn efficiency gap by 2019. This success is already factored into public spending plans laid out in the July 2012 High Level Output Specification (HLOS) and the spending plans for the 2014-19 Control Period 5. The DfT predicts passenger demand will grow by 16% and freight demand by 23%, yet total government funds available for the railways will only rise from £3.2bn in 2014/15 to £3.4bn in 2018/19.

This is a bold prediction when the DfT White Paper also admits that existing incentives involving financial support can have all kinds of perverse and unintended consequences:

*Once maximum Government support for train operator revenues is triggered, train operators have little incentive to invest or improve services in order to grow passenger numbers since they receive so little of the extra revenue generated. Unless care is taken, there is a risk that this issue would be exacerbated by the move to longer franchises, as economic conditions in the later stages of a franchise carry greater uncertainty.<sup>305</sup>*

But the White Paper believes that a new regime of incentives can dramatically improve performance rather than create a different kind of perversity. The White Paper's new regime is twofold: first, it puts more weight on physical outcome metrics for passengers; second, it supposes (private and public) financial benefits will flow from a McNulty style integration of train operating and infrastructure through "super TOCs" at regional level which will align financial and physical incentives.

We would begin by noting that the DfT's optimism about 'efficiency gains' under the new regime rests on much blurb about how higher passenger fares will increase sales revenues and workforce concessions can deliver cost reduction. Franchisees will now gain greater control over ticketing and scheduling. The DfT ostentatiously rejects 'demand management to price people off the railways' but does accept the need for 'rewarding passengers who do not travel on the most crowded trains, and asking those passengers who drive the need for capacity enhancements by travelling at the busiest times to pay more'.<sup>306</sup> In practice, this kind of pricing probably means much the same thing. In terms of the workforce, the DfT adopt wholeheartedly the McNulty proposals for 'modernisation of working practices', such as driver-only train services. In its win/win frame, the DfT is optimistic that cutting labour costs will drive demand and thus create more jobs (p.59-60). But, of course, there is no solid evidence for this view.

If we discount the DfT's consistent bias towards optimism on tricky conflicts and choices, the remaining problem is that physical targets and integration of operating and infrastructure are likely to deliver much less than the DfT plans. The White Paper proposals (and their subsequent development in the 2012 output specification) are developed and critiqued below.

<sup>305</sup> CM 8313, p.46.

<sup>306</sup> CM 8313, p.22.

The new regime for super TOCs is to be based on physical targets because the DfT now proposes ‘a shift from detailed inputs to broader outputs focused on passenger satisfaction’.<sup>307</sup> The July 2012 High Level Output Specification (HLOS) spells this out in greater detail. Though no specific targets are set, the DfT expects an improvement in Passenger Focus’ National Passenger Survey with punctuality and capacity explicitly targeted. By the end of CP5, the DfT wants an annual average of 92.5% of trains to be arriving within five minutes for regional and London and South East services, and 10 minutes for long distance services. The metric for increased capacity is numbers of arriving passengers at key stations. For Birmingham, Leeds, Manchester and ‘other urban areas’ by the end of CP5, the target is 20,100 extra passengers arriving during the peak three hours by 2018/19. For London stations, the target is an extra 119,000.

This new regime of targets bizarrely combines Soviet style output planning with consumerism because it is all being done so as to ‘put the customer first’. These metrics have the fundamental defect that, as argued in chapter 6, they narrow the public interest into consumer satisfaction. And practically, it is hard to see how a mixed set of metrics can lever improvement in anything meaningful.

Some of the metrics are much more relevant than others. Increased capacity, especially through patching investment, is crucial to the system going forward. But, now that we have recovered from Railtrack’s speed restrictions, timekeeping and punctuality is possibly something that we should be able to take for granted. With a mixed set of metrics, it is also quite hard to see how the outcome can be anything but a confusing spread sheet which shows that some targets have been met and others missed (without much contextual explanation); and the super TOC operating effort will then be distorted and directed by whatever the ORR offers as reward or punishment.

Physical targets will certainly not drive major cost reductions, which will have to come from structural reform. The DfT endorses McNulty’s recommendation for the break-up of Network Rail and its integration with super TOCS alongside devolution of accountability and decision making to the industry.<sup>308</sup> The claim is that this will ‘ensure the prevailing industry culture shifts decisively from an attitude of ‘My trains, your tracks’ to a shared focus on ‘Our railways’.<sup>309</sup> Leave aside the issue that this concedes that the division of responsibilities for track and trains was a mistake, the question is whether reintegration on these terms can drive cost reduction and that is immediately difficult to answer because the changes are complicated and involve the rollout of several different organisational models.

The supposed financial benefit of integration is that it would involve exposing TOCs to some of Network Rail’s costs through a Regional Efficiency Benefit Share where TOCs are rewarded or penalised according to: Network Rail exceeding or missing its efficiency targets on specific routes (this was introduced on a national level during CP4); changes in cost imposed by regulatory reviews;

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<sup>307</sup> CM 8313, p.26.

<sup>308</sup> CM 8313, p.29.

<sup>309</sup> CM 8313, p.40.

and compensation for engineering works and unplanned delays in order to make partnerships that focus on cutting costs and removing 'bureaucratic burdens'.<sup>310</sup>

While recognising that 'the ability of train operators to bear risks has limits', the ORR and DfT are designing new Track Access Agreements in time for the beginning of the 2014 Control Period, which establish the basis for collaboration on cost reduction. They also stress, following McNulty, that a one-size-fits-all model will not work, and so the specific form of alignment will differ across the network, with deeper alignments favoured in areas where single train operators dominate.<sup>311</sup>

The ORR have meanwhile encouraged the industry to take the initiative with proposals for further project-based 'alliances' (e.g. around engineering work, station maintenance, control centres etc.), where risks and benefits are shared, with a view to more formal 'comprehensive commercial arrangements' in due course.<sup>312</sup> Network Rail immediately after the McNulty report established Route Managing Directors with devolved responsibilities and a separate P&L account for their route – enabling comparative performance assessments by the ORR and setting the stage for more fundamental devolutions.<sup>313</sup>

A pilot for 'deep' alliance working within the existing system is being carried out at present between Network Rail and South West Trains to improve efficiency in the Wessex area, while the 2011 Greater Anglia franchise for the first time gives a TOC responsibility for maintenance of some stations. The more radical forms of integration outlined in McNulty – long-term concessions for infrastructure management by a third party, or full vertical integration – will come into being, the DfT says, 'as soon as Network Rail is ready' and, in the case of vertical integration, pending further investigation into compatibility with laws on competition, fair access to infrastructure etc.<sup>314</sup>

This will essentially amount, the DfT says, to Network Rail having to 'invite other companies to compete against its core business'.<sup>315</sup> Kent, Wessex and Anglia have been mooted, and in April 2012 Network Rail established an 'Infrastructure projects unit' as 'the first step towards a separate Infrastructure company acting as a supplier for regional and central project teams, competing against external providers'.<sup>316</sup>

Reintegration of the rail system is physically and financially desirable (as everybody accepts that the track owner versus train operator division creates conflicts of interest, which we would argue are exacerbated by contractualism). But it is extraordinarily hard to see how reintegration on these terms, with a greater role for the TOCs can drive financial cost reduction on the scale required. The arguments on this point are straightforward.

The break-up of Network Rail makes sense in a McNulty/DfT problematic where Network Rail is defined as a centralised obstacle, but it clearly cuts against 'whole-system' governance of a national

<sup>310</sup> This was outlined in greater detail in the ORR's 2011 periodic review of incentives [http://rail-reg.gov.uk/pr13/PDF/pr13-first-consultation-incentives\\_141211.pdf](http://rail-reg.gov.uk/pr13/PDF/pr13-first-consultation-incentives_141211.pdf); CM 8313, p.41.

<sup>311</sup> CM 8313, p.41.

<sup>312</sup> See <http://www.rail-reg.gov.uk/upload/pdf/alliancing-policy-statement-march-2012.pdf>

<sup>313</sup> It has also proposed the establishment of a centralised System Operator function to retain with NETWORK RAIL national control over timetabling, capacity allocation, network planning and sale of access; CM8313, p.44.

<sup>314</sup> CM 8313, p.44.

<sup>315</sup> CM 8313, p.52.

<sup>316</sup> <http://assets.DfT.gov.uk/publications/hlos-2012/railways-act-2005.pdf>

rail network, which underwrites financial and physical results. The DfT proposes to fragment the only organisation in the rail sector which at present has any whole-system responsibilities. And, rather alarmingly, the only replacement at national level is a voluntary industry-led forum of CEOs in the form of the Rail Delivery Group. We doubt whether committee dialogue between actors with often divergent interests will be sufficient to create national coherence. How is it possible to run a national system without either effective fixed institutions or organisation?

At regional level, the plans for integration will most likely work for the private rather than the public interest, creating new opportunities for value extraction. To begin with, this is a pathological variant on one size does not fit all. The DfT is promoting reintegration around a multiplicity of different models (from project based alliances to full vertical integration) which are only alike in that none of them are tested and all are being introduced into a system where predatory contractual behaviours are the norm. The result is likely to be a massive increase in complexity which will have unintended consequences and increase opportunities for value extraction through positioning and game playing.

Our misgivings are increased by the way in which longer franchises are being officially promoted as a way of bringing in private investment;<sup>317</sup> while TOCs practically gain new opportunities to tap up the state, which provides or guarantees investment funds. The DfT accepts that the private sector is most likely to invest in stations, ticketing systems and such like, but also supposes it is 'not realistic'<sup>318</sup> to expect larger private investments in rolling stock and major infrastructure upgrades. So, TOCs will get more opportunity to spend government money. As part of the alignment of the TOCs and a decentralised Network Rail, TOCs would be enabled to finance infrastructure projects using Network Rail's regulatory asset base (RAB), from which the government guarantees a set return.<sup>319</sup>

McNulty and the DfT's *Putting the Customer First* represent a recurrent pattern of regime change, which inaugurates the next instalment of serial shambles. Since well before privatisation, railway policy has worked through continual hurried improvisation and hyperactive reorganisation, masquerading as a rational reform process. At each major regime change, previous messes are one way or another written off, while the lessons of earlier failures and limited success are never learnt and new contradictions are built on the foundations of old unresolved problems.

In the current round of reform, the unspoken hope of all the players (corporate and political) is that Network Rail's wrecked corporate balance sheet and £30 billion of debt can somehow or other be left behind through reorganisation; it will quite definitely not be inherited by the enhanced regional super TOCs who would never accept their share of Network Rail's interest burden. And there is no sign that anybody has thought through whether and how to control enhanced TOCs which in an integrated system will have access to a state funded capital account; nor is there any mechanism for identifying and rapidly dealing with unintended consequences and new loopholes as they are found and exploited by position seeking firms.

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<sup>317</sup> CM 8313, p.34.

<sup>318</sup> CM 8313, p.47.

<sup>319</sup> CM 8313, p.33.

The current reforms will not produce a rail network, which is simpler, more coherent or more aligned, but just a new set of fragmentations, misalignments and contradictions around a new set of interfaces between the DfT, the ORR, the ROSCOs, the TOCs and Network Rail. The practical outcome is that it will allow a fundamentally unworkable system to stagger on zombie-like when it should be dead and buried in the public interest. In the next chapter, we make more radical reform proposals, which are in the public interest and address long standing cost recovery problems as well as the shambles of the past twenty years.

## Chapter 9: Policy recommendations for a different future?

### From serial shambles to triangulated policy

How to think effectively about rail policy? And think effectively when noise, complexity and political framing generate confusion that gratifies corporate business interests but delivers serial shambles for the rest of us.

This chapter argues for a new kind of triangulated approach to policy which starts from key questions which are rooted in the analysis of sector specifics provided in the earlier chapters of this report. If railways are about social connectivity, we must address out of sector fundamentals like tax reform and propose practicable structural fixes.

The first problem with rail policy is the *noise*. There are so many voices, so many positions, and so many special interests. Policy on HS2 is drowned out by NIMBY special pleading by southern protestors – or the wealthy in George Osborne’s Tatton constituency in Cheshire. The West Coast main line franchise is reversed because Virgin Trains has deep enough pockets to take the DfT to court. And the TOCs are busy lobbying for the creation of super TOCs.

The second problem is the *complexity*. For, yes, as we have shown above, rail is all pretty complicated. The details of franchising are understood by very few. Bringing the necessary skills together to understand what is involved in bidding – is a pretty tall order. And much of what is involved is commercially secret too. Despite the scandals, what happens and why it happens is more or less opaque

And then the third problem is the *intellectual and political framing*. You take a lot of noisy special interests. You combine their special pleading with the complexities and technicalities. And then you add the commercial secrecy, put it together with a complete lack of interest in the history of railways and their uncertain balance between private profit and public good, and what do you get? The answer is that you get a particular way of thinking about trains that is, as with McNulty, spectacularly blinkered.

In practice this means that government policy is esoteric confusion spread through the medium of documents from the ORR and the DfT and generated by self-promoting business interests. There is a jumble of policy recommendations and a further jumble of authorisations, contracts, and decisions whose only principle is the recommendation for super TOCs in official reports from figures

such as McNulty and Brown etc. But they are all framed within a logic of the business world whose priorities are taken for granted. 'It will be more efficient if we indeed entrench super TOCS.' Railtrack debt? For the business interests asking for more investment in railways this is neither relevant nor recognised.

## So what is to be done?

In many ways it isn't obvious. We are where we are, in a muddle of entrenched interests, unknowable technical complexity, and taken for granted and unquestionable assumptions which have turned the railways into an intractable problem. But one thing is clear. Unless we are content to live with more of the same, then policy making needs an approach that is more discriminating. It needs to relate to sectoral realities on the ground. But it also needs to reflect: on history; on how the arguments get framed; and most of all, it needs to think hard about what railways are actually for. This won't be easy and this is why we recommend a new kind of triangulated approach to policy.

The triangulated approach would work simultaneously on three related sets of issues and imperatives in the rail sector which come directly out of this report and the earlier analyses of authors like Wolmar and Gourvish.

1. *We should recognise the intractability of historically embedded problems and unreal assumptions* which drive non-solutions and accumulating contradictions that simply deliver further instalments of serial shambles. Here we would focus on the long-standing historical problem about cost recovery from fares and the prior, fundamental question about what railways are for.
2. *We should recognise that effective policy must combine a tactical approach to policy fixes with a strategic approach to fundamentals which is grounded in sector specifics* so that the fixes take us towards or anyway do not obstruct the tackling of fundamentals. At present tactics are being decided by business interests which close off strategic thinking with their self-serving assumptions.
3. *We should recognise that policy involves telling people what they do not want to hear* because uncomfortable words are a precondition for effective action. Compare and contrast the many ways in which our present policy machine is about telling people what they want to hear; in the expert sphere through think tanks producing front-bench-ready policies; in the popular sphere through the Blair-Mandelson practice of spin after focus group consultation; and in the lobbying sphere through ATOC's line about TOCs delivering for the travelling public. This form of politics is completely dysfunctional when capitalism isn't working and the rail sector has intractable problems.

To be clear, we don't for one moment believe that we ourselves have all the answers and we are going to say very little about the third issue of the form of our politics except right at the end of our argument. But we can add analysis and would then insist that it is important to separate out different strands of argument. In line with the triangulated approach, we suggest that it is important to distinguish between a hierarchy of interrelated issues (economic and social, technical and political) on the one hand, and different levels of intervention involving policy fixes and rethought fundamentals on the other. Our hope is that if we can separate these out it may be

possible to avoid the naïve cycle of reform and disappointment that has dogged privatisation for the past twenty years – but also the nationalised railways in the post-war period.

## So what does this mean in practice?

We want to suggest that we need to pose three separate questions:

- What are railways for? This is the first. It is important to address the issue of framing. Wolmar and Gourvish both make the point in their different ways. The question is both simple but fundamental. For if we ask what railways are for, there are several different answers. In particular we will need to debate the merits of connectivity as *narrow economic good* as against connectivity as a *broad social right*. And then we need to appreciate that depending on how we jump on this we will have quite different kinds of policy, and different kinds of railways in the future. But, if we have the debate, at least we'll be clear about how we are framing our thinking about railways, and that framing is not being debated now at all. The default (but faulty) option is that railways are about narrow economic goods, though in practice other options are also confusingly influential.
- Can we create the necessary environment for a social railway? Second, if we are committed to a version of the world in which railways are about broad social connectivity, then it becomes important to recognise that this is not a stand-alone issue of sectoral organisation. The vision of railways as a form of social connectivity has much broader preconditions across our polity. Social connectivity can only be delivered, in the end, if we are able to develop a series of new social and political tools and techniques that are currently not available in the UK. In particular, we will need to foster novel kinds of expert knowledge, change the distribution of financial resources, create alternative tax regimes, and develop different, devolved, understandings of political power.
- Can we create an interim public service approach that might be implemented after the next general election? This is the third question. The radical approach above is exciting for those of us who want to treat railways as a social good, but we are a long way from this. This means that we also need to address a thoroughly practical issue: what can be done in the shorter term given the muddle that we are in? The key here is to identify useful and practicable changes that would ideally cost no more than existing policy but would remove obstacles to thinking – and acting – more clearly about the railways. The object would be to set the right direction of travel by opening the way for more fundamental political and technical change. Here the reforms include politically controversial but nevertheless feasible short or medium term measures, starting with the abolition of the TOCs because they distort the political reform agenda through their option on profit.

In what follows we reflect on each of these questions.

### 1. What are railways for? Connectivity as economic good or social right

For the last 150 years railways have physically moved passengers and freight efficiently and done so in the absence of a working business model for recovering financial costs from users. Total revenues have required top-up, parts of the system have needed heavy subsidy, and revenues have also varied cyclically so subvention requirements have been difficult to plan. The funding gap between

passenger revenue and railway expenditure is currently around £10 billion a year. Our calculations suggest that in 2011-12 the funding gap was £9.6 billion comprising £5.7 billion for Network Rail's capital investment and £3.9 billion of operating support. This tells us that passenger revenue covered only 65% of operating costs.

Historically the problem has produced a variety of solutions within (and between) the two alternative problem definitions that we have touched on above.

**A. *Connectivity has been narrowly defined as economic good.***

This framing implies that only those services with sufficient revenue streams from passengers and freight should (in principle) be provided. This argument has been regularly deployed since the Beeching Report of 1962 which anticipated the triumph of road transport. That is the theory. But immediately the complexities crowd in, since in practice railways have not gone the way of canals to the point of becoming a leisure facility, and the economic model of cost recovery has never been fully implemented in the fifty years since Beeching. This is because railway neglect and downsizing is not an easy option: there are too many entrenched social, political and economic interests in continued service provision.

Since very few have been prepared to follow this narrow economic policy of cost recovery through to its logical conclusion, the railways have been subject to constant political pressure to suspend economic calculation, both by putting in new investment and by avoiding closures of loss-making lines and services. The results are visible in the physical configuration of the rail network, and especially in London where many of the most powerful private players like the City of London Corporation have a strong vested interest in publicly underwritten efficient mass transit. The hugely expensive upgrading of London's rail infrastructure began with the Victoria line opened in 1968; the Docklands Light Railway opened in 1987; the Jubilee line was extended in 1999; and upgrading is now being continued with the current large-scale Thameslink and Crossrail schemes. All these projects are signs of resistance to narrowly conceived arguments about economic goods. Outside the metropolitan region the many minor successes of anti-closure campaigns include the Settle and Carlisle main line or the Aberystwyth to Shrewsbury single track line which survives because it runs through so many marginal constituencies.

This kind of political interference to a straightforward 'user pays' model is always at work, but it is then resisted and countervailed in turn by economic arguments for shifting more of the burden onto passenger (and freight) revenue. One example is the current government target for recovering 75% of costs from passenger fares.<sup>320</sup> If such targets are taken seriously, then they involve continuous pressure for adjustment involving some combination of higher fares, a smaller network, and less frequent services.

The political struggle around cost recovery has been accompanied by the assumption that economic cost/benefit calculations should have a privileged status. These have been applied to possible projects and decisions about pricing. *Inter alia*, such calculations have led to scepticism about rail fare subsidies, since survey evidence shows that rail passengers typically have above average

<sup>320</sup> The target was set in 2007 for achievement by 2014. See BBC, 'Rail fares Q&A: Why are they going up again?' 2 January 2013. Available at <http://www.bbc.co.uk/news/business-19198342>.

incomes. Likewise, the case for projects such as HS 2 rest (and will rest) in large measure on cost benefit analysis. Here a key variable is the value of saving the time of business travellers which rests on assumptions about whether they can work productively on train journeys. These expert calculations survive even though, ever since the 1971 Roskill inquiry into London's third airport, they have been doubted by economists and derided by non-economists.

***B. Connectivity has been defined as a social right.***

This, as we noted above, is the major alternative position. In this way of thinking rail transport has been seen as part of what CRESC researchers call a wider 'foundational economy' which delivers everyday necessities that include the utilities, health, and education. Since 1945, the political assumption has been that a high income society can afford to include all citizens by giving them a right to a minimum level of safe food, clean water, warm houses, education and health care and mobility. Though, to be sure, entitlement is uncertain because decisions about how these goods and services should be paid for are very variable. Most of health and large parts of education have been free at the point of delivery while (arguably inadequate) welfare payments have been available for low income citizens to assist them to pay for basic necessities which are usually priced in non-social ways.

Mobility has not of course been an everyday necessity for most of human history and, if we go back to the nineteenth century, then Hardy's Wessex shows how rail mobility can be an upper income prerogative. From this point of view, the question is whether mobility (or what kinds of mobility) should be added to the long list of everyday necessities in twenty first century society: should rail travel be included as a means to mobility unlike air travel which many would argue is still a luxury and appropriately a matter of discretionary spend? The argument about mobility as an everyday necessity in Britain now is partly a matter of historic demand trends and revealed preferences: consumer spending on mobility and the number of journeys taken increases with income, whether we view this across income levels or over time; this is why the number of railway journeys has increased over the last thirty years and why much of the commuter and long distance railway system now has capacity problems.

As we have seen, car journeys dominate and are likely to continue to do so for non-radial travel. Significantly, there are roughly as many cars as the 30 million workers in the UK workforce. Nevertheless, most people in a high income society like the UK also need to make long distance journeys by rail. The difference between high income and low income groups is that the rich make more journeys: according to the latest transport survey, those in Q5, the highest income quintile make two journeys by rail of more than 100 miles each year whereas the poorest in Q1 make 0.6 such long journeys. In short, those on social security or the minimum wage are more income constrained but much like the rest of us: the poor also have relatives, friends or job interviews at the other end of the country. And 30 % of all who travel for leisure by rail come from households without access to a car.

There is also an element of economic necessity, or at least connection with workforce participation, for what the newspapers call "the squeezed middle". According to the 2010, national rail transport

survey<sup>321</sup>, commuting accounts for 63 % of all rail journeys. Those on the lowest wages are trapped in local labour markets and cannot afford to commute. But commuting is not the prerogative of accounting partners and city lawyers; the largest single group of commuters, some one third of the total in the 2010 survey, have household income of £17,501 to £35,000 which puts them somewhere around the mean. Rail commuting underpins workforce participation by middle income groups who cannot afford to live in or near inner London. One of the corollaries of the property bubble of the 2000s was more commuting by those dispersed by the housing market and the concentration of rail passenger growth in the London and the South East.

These kinds of social arguments about connectivity point to the relevance of a different area of expertise which is represented by town and country planning (rather than economics). The central insight of the planners with respect to railways is that many journeys are not radial (ie to and from London or in and out from the centres of our major conurbations), and such journeys often involve interchange between poorly integrated transport systems. This tells us that projects like HS2 are meaningless unless fares are set low and transport intersections are sorted out. And, more generally, it also tells us that the problem with connectivity is not that we lack experts to think it through. The issue is rather who pays for connectivity and how this should be done, when fares do or should not cover costs.

The opposition between these two models – economic good on the one hand and social rights on the other – presents awkward choices which many, both inside and outside the political classes, have tried to avoid by emphasising the developmental benefits of infrastructure. The assumption here is that if we build infrastructure, we will grow GDP and benefit districts or regions that are lagging behind. So while cost recovery may be a problem, the argument is that transport investment has inbuilt economic compensation mechanisms. This assumption is seldom criticised because so many disparate groups believe that infrastructure will give them what they want. In the liberal framework which now dominates regional policy, infrastructure and training are the only two acceptable forms of intervention because it is taken for granted that they make the market work better rather than distorting it. And spending on infrastructure is seldom challenged by Keynesians, local authorities or trade unions for whom infrastructure means jobs; while property and construction companies lobby for policies that will increase their profits.

Politically, it is easy to see why infrastructure is more or less universally popular amongst those for whom it does not run through their back yards. Absence of transport connections hobbles development. This is obvious if we consider the pockets of deprivation in London like the Upper Lea valley or those south coast towns without a fast train to London. What French planners call ‘désenclavement’ is a worthy policy objective: one good link can indeed transform an isolated district. But we also need to curb our enthusiasm. The provision or improvement of transport connections does not guarantee development. Thanks to the vision of its county surveyor, James Drake, Lancashire acquired the best regional motorway network in the UK; but this has not brought post-industrial development to depressed ex-textile towns. So, if there is no automatic compensation mechanism via economic development, the problem remains: how are railways to be paid for?

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<sup>321</sup> National Rail Transport Survey, Overview Report, December 2010 update, Department for Transport.

### C. *The three fundamental preconditions: redistribution of financial resources, political authority and expert knowledge*

These are the framing issues that need to be explored if we are to think sensibly about railway investment and policy. And if the problems of rail finance have remained unsolved for more than a century this is not a coincidence. This is because they belong to a special category of ‘*socially intractable problems*’.

A socially intractable problem is one that is difficult to solve because it requires the invention of *new social technologies*. And those technologies, though they may be imagined, are difficult to implement because their adoption demands fundamental redistributions of resources, power and knowledge: innovation runs, in short, up against political resistance. So it was in twentieth century Britain, when the extension of new rights to income maintenance and health care was built on new social technologies such as contributory insurance funding and PAYE income tax for working people. And if new social technologies are difficult to implement in general, this is all the more so for railways where many think of them in narrow economic terms rather than social goods. Looked at from a social right point of view, however, the inventiveness of nineteenth century rail engineering has never been matched by social innovations that would make it possible to raise revenue from non-users in a way that commands political assent.

Our discussion of policy and new social technologies in this section is thus a kind of thought experiment because it deals with changes that are most unlikely to become pledges in the manifesto of any major party in the near future. Even so, we need to explore these issues because they indicate the scope of the problems that need to be addressed, and the constraints that must necessarily be shifted if we are to solve the problem of funding rail transport and developing the network in a context in which passenger fares yield an inadequate revenue fund and some parts of the network require heavy subsidy.

Put another way, the issues are important because they demonstrate the point that there is no fix that can solve the problems *within* the rail sector without fundamental reinvention *outside* the sector. This is the absolutely central point which is missed completely by most of those who discuss rail and other intractable social problems such as social security or banking reform. They are intractable exactly because so many out-of-sector or out-of-system issues have to be aligned or reconfigured; an intractable problem never yields to direct assault.

#### A. **Basic reform of the taxation system**

This is needed because there is a fundamental gap between small and often negative private returns via fares and large, positive social returns by parallel mechanisms, and especially increased land prices.

The construction of new railway lines or the improvements of existing lines almost always generates an unearned increase in land and property prices for businesses or households close to stations or new hubs. For instance Riley (2001) describes how a Southwark station site purchased for £100k was sold for £ 2.6 million a year after the Jubilee line was extended<sup>322</sup>. We argue that

<sup>322</sup> Riley, D. (2001), *Taken for a Ride*, Centre for Local Policy Studies, pp.23-25.

public investors (and therefore ‘society’) have a prior claim on the value they create and from which private urban land owners make such windfall gains. The potential here is considerable because the increments in land value in major cities are often much larger than the cost of railway construction<sup>323</sup>. This point has been made in studies of the Washington DC Metro system<sup>324</sup> and we would expect similar results for London underground and Manchester tramways.

The new social technologies we are recommending here are relatively straightforward. On the one hand, compulsory purchase could make railway extension and improvement projects partly self-financing if land was purchased at pre-improvement prices in corridors and hubs adjacent to planned facilities. And on the other hand, railway services could be sustained if we were to move to a land value tax.

The arguments in favour of land value tax have been widely rehearsed since the late nineteenth century when Henry George proposed an annual tax on the market rental value of land. Indeed a land value tax was a staple demand of Edwardian radicals and was included in Lloyd George’s 1909 People’s Budget before the measure was lost in the House of Lords<sup>325</sup>. But in the UK more recently, it has been a more or less undiscussed option in main stream politics. Tax reform was bodged by the Thatcher government which funded cuts in income tax rates regressively by shifting the burden of state expenditure to VAT and consumption taxes. After 1979 unearned increments from rising house prices were used to underpin private consumption rather than social objectives. As CRESC research has shown<sup>326</sup>, housing equity withdrawal was larger than nominal GDP growth in both the Thatcher and Blair premierships.

We do not underestimate the technical difficulty or political resistance to land value tax in British society where those who benefit from capital gains on property expect to benefit from unearned increments without political discussion or challenge. Nevertheless such a tax would logically underpin social cost recovery from investment in a railway system understood as a collective good.

## **B. Regional government within a federal polity**

This is needed to provide a framework for political accountability and financial cross-subsidy as long as the railway system has to provide both an integrated national network and intra-regional services.

If regional governments had tax raising powers, in areas like Wales or the North East, some of the regional requirement for subsidy and investment could be met by locally raised taxes while the rest could be met by transfer from the centre. The potential of such arrangements is illustrated by the £235 million Scottish Borders project for building 35 miles of new line which reinstate Beeching cuts: this is “funded by the Scottish government with fixed contributions from Midlothian and

<sup>323</sup> Rybeck, W. (1981), ‘Transit induced land values’, *Commentary*, pp.23-27.

<sup>324</sup> Smith, J. and Gihring, T. (2006), ‘Financing Transit Systems Through Value Capture: An Annotated Bibliography’, *The American Journal of Economics and Sociology*, Vol. 65, No. 3, July; pp. 751-786; at [www.vtpe.org/smith.pdf](http://www.vtpe.org/smith.pdf)

<sup>325</sup> Short, B. (1997), *Land and Society in Edwardian Britain*, Cambridge University Press.

<sup>326</sup> Erturk, I. *et al.*, (2011), ‘City state against national settlement’, p. 33, CRESC Working Paper.

<http://www.cresc.ac.uk/sites/default/files/City%20State%20and%20National%20Settlement%20CRESC%20WP101.pdf>

Scottish Borders Councils<sup>327</sup>. Regional government with tax and spend would relate political accountability to deficit financing in a way that is impossible in the present Westminster-dominated system where London ministers take decisions on behalf of the regions and 80% of local authority expenditure takes the form of grants from central government. At the same time total devolution is neither technically nor politically sensible. Central government needs to retain some responsibility for standardising equipment and procedures, and for the main lines that run through several regions.

If we step back from the railways then it is worth noting that it is almost certainly more than a coincidence that London's surge of economic activity, which has moved it so far ahead of the rest of the UK, accelerated after the introduction of what is in effect a form of regional government for London. Whatever the defects of the mayoralty and GLA system, it has provided London with a powerful voice together with leverage over transport improvement. This suggests that even without significant revenue raising powers institutional reform can greatly enhance the capacity of a region to make its voice heard in policy debates. Analogous arguments, though with revenue raising powers, may be made about the Scottish Executive's initiative in pressing the case for the Borders railway.

Here again, rail reform comes up against the consequences of the earlier policies of Thatcher and Blair. Thatcher was a centraliser who abolished the Greater London Council and the metropolitan counties in the other English conurbations in 1986; so that all our largest city regions had no proper upper tier authority with the clear authority to plan transport. Blair promised English regional government but never delivered it mainly because New Labour was not clear what regional government would do apart from adding another layer of government elected on low turn outs. But if rail planning – and transport planning more generally – is to be done well then this is a core reason for developing English regional government: it is a crucial foundational role for regional government.

### **C. A redistribution of social knowledge is necessary because current policy is built on lack of knowledge and a self-serving business agenda.**

When considering social knowledge, the additional problems of expert and lay knowledge need to be separately addressed. On the one hand, a redistribution of expert knowledge is the precondition for the political formulation of sensible policy choices and the appraisal of policy outcomes. On the other, a level of informed lay knowledge is needed for political participation in a democratic process at national or regional level

The breakup of the old economic and social settlement under Thatcher and Blair has increasingly concentrated expertise in locations where it can be paid for by the private sector. Thus, the TOCs have corporate lawyers, tax advisers and PR consultants who all provide focused advice; and rail industry managers are brought in as necessary to explain sectoral limits. The public sector is left with a sense of inferiority about its supposed inability to manage change and its onerous responsibility for contracting out. The discourse of reform and the employment of partisan ministerial advisers further undermine what remains of the independent public interest administrative expertise essential to any functioning polity if it is to debate alternatives even-

<sup>327</sup> <http://www.bordersrailway.co.uk/>

handedly. With very little protest, ministers have recently gained the power to appoint senior civil servants from a short list.<sup>328</sup>

Against this background, one of the first priorities is to rebuild and institutionally locate publicly available railway-related knowledge and dispersed independent expertise. This is essential if we are to make sensible choices and understand consequences, because lack of knowledge results in an inability to learn from mistakes or to engage with inescapable sectoral realities. The two most obvious loci for such knowledge are government departments and public universities.

The civil service at the DfT and elsewhere does not need more expertise in the management of outsourcing. But it does desperately need rail sector knowledge. The need is for a team where one of the key intermediate objectives should be to include and retain two senior civil servants with more than 7 years continuous experience of the sector. The public universities should be encouraged to broaden their academic mission and financially incentivised to build centres of rail-related expertise. The model might be that of the old agricultural economics departments. This would probably best be done by a national university competition for two publicly endowed interdisciplinary rail research centres, with one centre reserved for a university outside the Southern golden triangle.

Turning to the broader public, this is actively fed misconceptions by the rail lobby and has very little information on the privatised rail system. Many key facts are simply not in the public domain. One relevant test is to ask friends and family about the debt of Network Rail. All those we asked, first said they did not know and then guessed the total at less than half the £30 billion outstanding. This suggests the urgent need for a fully transparent and accessible system of accounting for the rail sector as a whole. Without this information, broadly based political debate about public choices will simply not be possible. Given the failure of the ORR and the DfT to make rail finances intelligible, independent academic accountants, such as Jean Shaoul and John Stittle, should be brought in to advise on the format for consolidated rail sector accounts. The basic need is to lay out the flow of revenues and subsidies in a way that makes the chain of interrelated profits and losses within the sector becomes visible, while at the same time highlighting all subsidies (direct and indirect) and avoiding off balance sheet sleights of hand.

#### **D. An interim public service fix, after abolition of the TOCs**

The argument so far is that any sustainable solution to the problem of railways as social connectivity depends on large changes outside the sector. But, as noted above, fundamental change in areas such as taxation reform and regional government will not be quickly achieved. The need, therefore, is also for interim public service improvements that would provide a platform for more thorough-going reform. These only pass the test of practicality if they are relatively inexpensive (at least in terms of current expenditure) so that they could be included in a mainstream party manifesto for the next general election.

The first step would be to introduce structural reforms which move away from the current trend of government policy. As we have seen, current proposals suggest the creation of regional super TOCs

<sup>328</sup> Pickard. J. "MPs seek bigger Whitehall jobs role", Financial Times, 19 December 2012, <http://www.ft.com/cms/s/0/02f4e9b0-4a04-11e2-a7b1-00144feab49a.html#axzz2LCTfsI3P>

to integrate train services and infrastructure. It is good to see government belatedly recognising that the separation of responsibility for trains and track was a fundamental mistake. We agree that in an underinvested network with many capacity bottlenecks, the aims of continuous operation and high capacity utilisation are most easily secured by a single integrated organisation. But when this fundamental point has been made, most of the rest of current government policy prescriptions could be usefully reversed.

## Six structural fix reforms for the rail sector

### 1. Structural fix one: abolition of the TOCs

The problem is that the TOCs manoeuvre for profit, in a context in which the government is committed to keeping them going. This combination has together completely distorted the agenda of rail reform. The abolition or marginalisation of the TOCs is therefore a crucial first step. Professional accounting and legal advice should be sought about how the TOCs could most easily be put out of business at minimum cost. Such advice is necessary since TOCs have rights to compensation for such things as higher track access charges within one control period, and their contracts vary according to their year of issue. But euthanasia of the TOCs is manageable within the life of one or two parliaments because they have relatively short leases with break points and there is no requirement for shareholder compensation when their franchises expire.

The question as to what replaces the TOCs on an interim basis – as well as permanently – then becomes the issue. It is important to have the integration of track and train as a long term organisational goal (as discussed in the next structural fix). But, franchises relinquished at different dates may have to be operated in the interim by a caretaker as Directly Operated Rail now does after franchisees walk away. A variety of interim arrangements are possible, but we would recommend not for profit as against fee for service arrangements. As we noted in our earlier argument, fee for service is economically sensible insofar as it redefines train operation as a utility and strips away the pretence that TOCs can, do, or should increase passenger numbers, reduce costs or take risks. But, if structural reform is intended, fee for service incurs the political risk that it would attract the same companies as now bid for franchises, which in turn means that corporate lobbying and agenda setting would continue.

### 2. Structural fix two: Integrate train and infrastructure in a new 'National Rail'

Train and infrastructure should be organised by a new not for profit company National Rail built around the core of Network Rail. In the absence of English regional government, National Rail would probably be best organised on a business division basis like British Rail in its last days. The argument for building a new company around Network Rail is that Network Rail is the only large national organisation remaining in the industry and, having taken maintenance back in-house, already employs some 35,000 people. An alternative would be to expand Directly Operated Railways (DOR) whose moderately paid managers have an exemplary operating record on the East Coast Main Line<sup>329</sup>. But DOR is much smaller and its operating knowledge

<sup>329</sup> The highest paid executive on the East Coast Main Line earns £160-180,000 whereas the CEO of ScotRail earned £330,000 in 2012. Kevin Rawlinson "Anger over £1million pay deals", Independent, 18 February, 2013.

and procedures could be integrated into National Rail through employment of DOR managers and procedures.

The present government is pursuing an alternative of building round the TOCs and promoting *de facto* TOC-led railway regionalisation. This is rather like the regionalisation policy adopted after World War One which was then rolled over into the BR regional organisation which predated business line organisation. Regionalisation (though not led by TOCs in their present form) would be attractive *if* the UK had effective regional government and the corporate boundaries of regional railways could be aligned with those of government. Without this alignment of boundaries, regionalisation of railways is a recipe for fragmentation and incoherence because functioning localism requires strong political institutions to enforce national standards and fund regional diversity.

There are several advantages of building on Network Rail.

- It is already a “not for dividend” entity partly owned by the TOCs whose removal would allow debate and decision about the best new forms of ownership and governance for National Rail. “Not for dividend” Network Rail is a cautionary tale about how the renunciation of (equity based) extraction is meaningless given the presence of controlling central government which reinstates other (debt based) forms of extraction. It is essential that publicly owned corporations should have some management autonomy and stakeholder representation as safeguards against abusive control by central government in matters with Profit and Loss account or balance sheet repercussions. The means need to be debated because public ownership is not so much a destination as work in progress.
- It is already a permanent, substantial national organisation which can be given responsibilities which would make no sense for a short life TOC which has no long-term stake in the system. Specifically, National Rail could be charged with large scale investment in training and responsibility for career continuity and management development in order to rebuild the British Rail stock of skills and competences which the rail sector has been living off and running down since privatisation.

The strategy has two disadvantages.

- First, National Rail can only operate sensibly after the existing Network Rail balance sheet is cleaned up and the £30 billion of publicly guaranteed debt is either paid off or converted into public debt (which is what it is already in all but name). This may be uncongenial because it is costly, but it needs to be done in any case because public subvention of the rail sector is increasingly confused by the interest burden on ten years of debt arising from a Treasury dodge. As the UK does not have a Japanese problem about high levels of public debt in relation to GDP or a South European problem about the cost of servicing debt, our recommendation is that this rail debt be consolidated as public debt This would not increase current expenditure.

- Second, efficiency needs to be secured. The extent and causes of any efficiency gap remain uncertain since Network Rail disputes McNulty's calculations of the inefficiency of its basic maintenance operations compared with European railways. But though the creation of an integrated large organisation will help, the efficiency of National Rail cannot be assumed or taken for granted. Increased efficiency needs to be levered in innovative but historically proven ways which are the theme of our third recommendation.

### 3. Structural fix three: Separate railway operations and capital expenditure

This is a matter of learning lessons of pre and post-privatisation history across different sectors in the UK. In railways, privatisation after twenty years has not delivered on the promise of increased operating efficiency through private management and profit incentives. But, on Gourvish's account, British Rail did indeed succeed in delivering operating efficiency and we would argue that this was because its management was constrained by scarce resources. As in other sectors such as health, with reasonable organisation and management information systems, the creative skill of the cash-starved public sector manager has always been to deliver a first rate service from outdated facilities with patchy investment. This approach comes at a cost in a sector like rail because it implies the neglect of essential investment, and this undermined public confidence in BR before privatisation; at the same time, an accumulating infrastructural deficit in sectors like rail would in due course make the public sector vulnerable to predatory private sector finance deals.

The lesson is that, when it comes to railway *operations*, we should put our faith in cash constraint and resource scarcity rather than profit mechanisms refracted through management incentives. But if National Rail operations were subject to cash constraints, it would also be important to fund capital expenditure separately and more generously. There is clearly a danger of leakage of cash between divisions within one organization, because the line between maintenance for operating purposes and new capital expenditure projects can be easily blurred and divisional costs can be massaged by internal transfer pricing. Therefore we recommend that National Rail be given responsibility for operations but that major capital projects should be the responsibility of a different new organization, called Rail Engineering. This would put major works out to tender (as with Network Rail at present) and take responsibility for managing rolling stock and planning its orderly procurement. The latter is crucially important if we wish to maintain a rolling stock manufacturing industry in the long-term.

### 4. Structural fix four: eliminate the ROSCOs by not renewing their leases.

In 2011 Angel Trains had nearly 4,500 vehicles leased to train operators and the leases of more than half these vehicles were due to expire between 2012 and 2015. When the leases expire, we recommend that the rolling stock should be acquired by the new Rail Engineering organisation, at realistic prices reflecting the fact that most of the trains are fully depreciated. The state, which was underpaid when BR's rolling stock was sold off, should certainly not over pay when ROSCO rolling stock is bought back. Rail Engineering should then be responsible for replacement schedules to reduce the average age of rolling stock and secure the steady flow of orders necessary to sustain the national rolling stock manufacturing industry.

## 5. Structural fix five: create a counter-cyclical mechanism for compensation for variations in GDP growth

We recommend recognising the cyclical nature of rail revenues by introducing a mechanism for compensating National Rail when GDP declines in recession or GDP growth falls below a trend rate (set realistically at a low level of around 1.5%).

The first principle of organisational design is not to hold managers responsible for events that they cannot control. Although GDP growth is a crucial driver of passenger numbers and revenues, railway managers cannot control the trajectory of the economy. The history of BR was one of panic about cyclically varying deficits. The importance of GDP driven fluctuation is now recognised by the DfT. As a result the TOCs will enjoy compensation for low growth under new franchises. The levels of compensation would need to be reviewed to ensure they are not an overgenerous response to TOC lobbying. But, in principle, if the burden of cyclicity were to fall on National Rail, the new organisation would need similar levels of compensation.

## 6. Structural fix six: Raise extra revenue with a rail precept to the business rates

A rail precept has been raised by the Mayor of London to support Crossrail.<sup>330</sup> The maths here both indicate some potential for using the existing tax system to raise revenue, and the limits of this resource which implies the need to think more fundamentally about new and different kinds of taxes on property paid by business and households. If we consider business rates, there are 1.9 million 'hereditaments' in England and Wales with a total rateable value of £59 billion and an average rateable value of £32K. Currently the rates multiplier on business is 43.3pence per £ of rateable value so that, after adjustments and exemptions, business rates raise £21 billion. This suggests that if Network Rail's investment were raised through increases in business rates, the latter would increase by approximately 25%. This is simply not practicable. However, if business and households were to make a joint contribution to infrastructure, the sums would become much more plausible and interesting. Some 21.8 million households are liable for council tax which (after adjustments) raises some £22.5 billion. Equal contributions from business rates and council tax could easily together raise £3 or 4 billion each year in the short run until property taxes were overhauled.

Would these six structural fixes put the rail sector in a better place? The answer is yes, but only in part. Together they would endow the railways with a sensible organisational form and operating management constrained to deliver operating efficiency. But at the same time it seems doubtful whether these changes would legitimise the organisation and operations of National Rail. It is then likely that National Rail's management would suffer from political disruption and the necessary level of capital investment would probably not be secured.

Operating losses were used as a stick to beat BR in the 1950s and 1960s. This was in a sunny period, when the economy was on a trajectory of growth and there was a front bench cross-party consensus on the inevitability of public ownership which was not seriously questioned either by back benchers or the media. By the 2010s, we could expect much more orchestrated and noisy

<sup>330</sup> 'Intention to levy a business rate supplement to finance the Greater London Authority's contribution to the Crossrail project' (Final Prospectus), Greater London Authority, January 2010.

shock and horror about the operating losses and investment subventions that would of course become visible in a reintegrated National Rail. GDP compensation is not a public issue when it goes to the TOCs, but would be represented as a subsidy if it went to National Rail. Higher property taxes would be a hard sell politically against a stormy economic background of little or no growth, continuing crisis and public austerity which now extends as far as we can see into the future. This would all be a trouble-making opportunity for those parts of the press and the Conservative party which are theologically attached to private ownership. The internal agenda-setting politics of the TOCs could easily be replaced by external disruption of National Rail by these un-reconciled political forces.

Put another way, while structural fixes would greatly help the sector, any progress is precarious and reversible unless and until we confront the fundamental question: if connectivity is a social good, then how is it to be paid for? For passenger fares do not and will never sensibly cover the cost of the railway system. Large national top ups and regional cross subsidies are inevitable. The silence of the Conservative Party on this issue is not surprising. However, the silence of the Opposition – its failure to move from moralistic generalisations to sector specifics – has to be challenged.

In last year's 2012 speech to the Labour Party, Ed Miliband advocated a "One Nation" politics focused on building our "common life"<sup>331</sup> In his speech to conference one year previously, he had reworked the old criticisms of financialized, short term capitalism for a world after the financial crisis. In 2011 Ed Miliband drew the distinction between "producer" businesses who train, invent, invest and sell and "predators just interested in the fast buck, taking what they can out of the business"<sup>332</sup> This was echoed in the subsequent British debate on the deficiencies of "banking culture" exemplified by Barclays and Bob Diamond and dissected by the Banking Standards Commission.

There are intellectual echoes of this approach in the Geoff Mulgan's<sup>333</sup> new book, subtitled "predators and creators in capitalism's future". And again in the more academic treatment of the corporation in Grahame Thompson's<sup>334</sup> recent book which argues that companies are not all the same. If there are good and bad businesses, then what is needed is more companies of the right kind with a greater commitment to collective goods such as citizenship and social responsibility.

But if so many of our intellectuals and politicians can agree that they are against sin and in favour of virtue, then how does this differentiate them and does it empower them to change capitalism for the better? The worry is that their headmasterly commitment to the moral high ground is mostly rhetoric and aspiration. If they want to change capitalism, they need, instead, to engage with sector specifics. That would bring recognition that changes in behaviour and culture and a different policy agenda all depend on the redesign of habitat and organisations which in turn requires politicians to confront the vested interests in corporate welfare and to envision fundamental change in out of sector systems such as taxation. But these are questions that they never mention.

<sup>331</sup> <http://labourlist.org/2012/10/ed-milibands-conference-speech-the-transcript/>

<sup>332</sup> <http://www.newstatesman.com/uk-politics/2011/09/britain-values-government-work>

<sup>333</sup> Mulgan, G. (2013), *The Locust and the Bee*, Princeton University Press, New Jersey.

<sup>334</sup> Thompson, G. (2012), *The Constitutionalization of the Global Corporate Sphere*, OUP, Oxford.

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