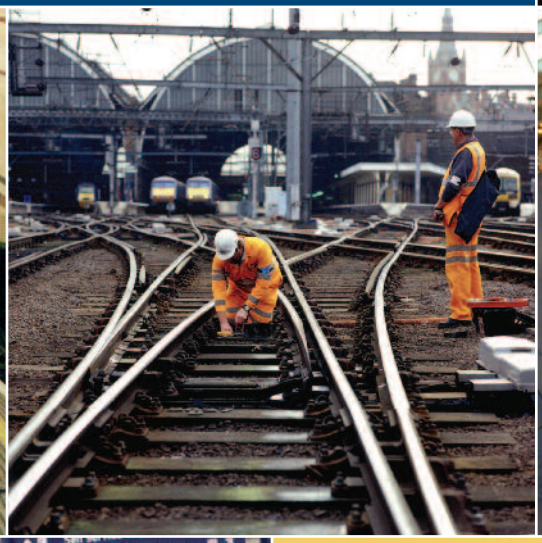
Rebuilding Rail

Final Report June 2012



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Disclaimers

1. The rail trades unions

The authors would like to thank Aslef, RMT, TSSA and Unite for their financial support of the research for this report. While all these unions support greater integration and public ownership of the railways, the views expressed in this report are those of the authors, and the proposals set out in the following pages have not, as of the date of publication, been adopted as official policy by any of these unions, and should not be taken as such.

2. Northern Ireland

This report does not deal with the railway in Northern Ireland. The problems caused by privatisation and fragmentation of the railways in other parts of the UK do not apply to Northern Ireland, where NI Railways has, so far, remained publicly owned and vertically integrated. In addition, Northern Ireland's railways physically connect to and relate to Eire rather than other UK railway lines. This distinction is reflected in the report's adoption of the name *'GB Rail'* to describe an overarching railway organisation encompassing both track and trains. Where the term UK is used in the report it should generally be presumed that the issue under discussion does not apply in Northern Ireland.

Acknowledgments

Interviewees

The authors would like to thank all the experts interviewed who gave generously of their time and deep knowledge of the railway. We emphasise that this report represents the view of the authors, not of interviewees, who, whilst universally critical of the present state of the railways, represent a range of viewpoints about how the railways should be reformed. Where quotes are attributed, they therefore should be read entirely in the context of the specific issue in question and do not indicate that the individual quoted endorses arguments presented elsewhere in the report, although we hope they will find much that they can support within it. The full list of those interviewed for this report is as follows:

Lord Andrew Adonis (Director, Institute for Government, formerly Secretary of State for Transport)

Aslef (Nigel Gibson, James McGowan, Simon Weller)

Ian Cleland (Freight Development Manager, Network Rail)

Cooperative Party (Joe Fortune, Pete Jefferys)

Mark Dowd (Chair, Merseytravel)

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Preface

The UK's privatised railway is failing society, the economy and the environment, whilst draining taxpayers' money into the pockets of private shareholders. Common sense and expert railway knowledge have ceded to a misguided private-must-be-best ethos, leaving Britain with a fragmented dysfunctional railway system that other countries view with disbelief.

Excessive costs in the UK rail industry have recently been highlighted by the McNulty Review. This study criticised waste from fragmentation and complexity in our railways, but ignored the obvious solution: simplify the system. Instead, the Review proposes more fragmentation. Analysts have predicted the McNulty approach would lead to older trains, higher fares, fewer services off-peak and at weekends, and more freight going by road[1]. Large sums of money would still be lost to inefficiencies of complex contractual agreements between dozens of companies.

This paper outlines a different recipe for reform. It shows that over one billion pounds of taxpayers' money could be saved every year by reuniting the railways under public ownership. All the public money invested in the railway could then be put to good use, delivering a better service for passengers while also achieving wider environmental and social goals.

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Executive Summary

The cost of the privatised railway

There is a widespread concern – shared across the political spectrum – that we are not getting good value from the substantial sums of public money that are invested in the railways every year. Since privatisation, the cost to the public purse of running the railways has risen by a factor of between two and three times. The most cautious view is that the public money going into the railways has increased from around £2.4 billion per year before privatisation (in the period 1990/91 to 1994/95), to approximately £5.4 billion per year in the period 2005/06 to 2009/10 (all at 2009/10 prices). Over the same period, the money going into the railways from passenger fares has also increased in real terms.

Much of the increase in cost may be attributed to fundamental problems with the complex privatised railway structure created by the Conservative Government in 1994. Key reasons for the increase in cost include higher interest payments in order to keep Network Rail's debts off the government balance sheet; debt write-offs; costs arising as a result of fragmentation of the rail system into many organisations; profit margins of complex tiers of contractors and sub-contractors; and dividend payments to private investors. Taken together, these represent a cumulative cost since privatisation of more than £11 billion of public funds, or around £1.2 billion per year. This should be considered a minimum figure, as it includes only those costs which may be most readily quantified.

To put these figures in context, if all unnecessary costs were eliminated and the resultant saving was used entirely to reduce fares, it would equate to an across-the-board cut in fares of 18% (or a substantially larger cut in fares that are price-regulated because of their social importance).

The effects of privatisation on passengers, freight and train manufacturing

The current structure of the railways affects passengers in several ways. Britain has Europe's highest commuter fares for both day returns and season tickets. Ticket purchase is excessively complex. When things go wrong, there is a lack of clear accountability.

Although the privatised rail freight industry might fairly be said to appear better than the rest of the privatised railway, privatisation has resulted in lost opportunities to expand rail freight. Leakage of public money out of the railway as a whole has reduced the funds available for investment in rail freight distribution centres; freight links to serve new industrial capacity; and expansion of the strategic rail freight network. Substantial reductions in rail freight track access charges (80-90% in real terms from the level immediately after privatisation) failed to stimulate growth in the rail freight market.

The UK's once successful rail manufacturing industry has been almost destroyed since privatisation, due to an overall level of investment that is too low to sustain manufacture and a stop-start procurement pattern. These problems arise from the absence, since privatisation, of any kind of 'guiding mind' for the whole railway that is able to plan a steady, economical procurement programme using domestic suppliers.

Perceived obstacles to reform

There are three broad categories of argument against reuniting the railways under public control: that involvement of the private sector brings valuable innovation, greater investment, and greater efficiency; that it would cost too much to buy back the assets that have been sold off; and that any action to reunify the railway under public ownership would contravene EU law.

However, the Transport Select Committee, the McNulty report, and the expert interviewees for this study suggest that innovation is discouraged by the complex and fragmented structure of the privatised railway, and is more difficult now than it was before the railways were privatised. The hoped-for innovation has not materialised.

Genuine at-risk private investment (as opposed to private capital expenditure that is underwritten by the Government) makes an insignificant contribution to the railways, representing of the order of one per cent of the total money that goes into the railway each year. This is substantially less than the additional costs posed by the privatised structure.

Privatisation has also failed to increase the efficiency of the railways. Notably, this appears to be due to increased numbers of administrators and managers. The cost of these 'back room' staff has increased 56% since privatisation, measured per train kilometre. Fragmentation has produced duplication of functions in the different private companies and new staff to deal with all the interfaces between those companies.

A step-by-step approach would enable the railway's assets to be reacquired for the public at minimal cost, and with substantial ongoing savings over time. This step-by-step approach would involve acquisition of franchises as they expired or as companies failed to meet franchise conditions; bringing Network Rail's debt back onto the Government balance sheet (resulting in lower interest payments); direct procurement of new rolling stock; and 'fair price' regulation to bring down the cost of leasing existing stock from the rolling stock companies that now own it.

European legislation does not dictate that railways must be fully privatised. There is no requirement under EU legislation for railway infrastructure to be in private ownership. Nor is there any bar on train services being operated by a Government-owned enterprise. Other EU countries have accommodated EU legislation whilst largely or entirely retaining public ownership of their railways, and the most recent proceedings at the European Court of Justice suggest that this is likely to remain the case in future.

What our railways *should* be for

Railway reform should seek to provide a high quality service that passengers understand, with simple system-wide ticketing and affordable fares. It should tackle overcrowding by expanding capacity; help stimulate local economic regeneration through better services; help rebuild a UK rail manufacturing base; expand urban rail networks as a means to create uncongested and more livable cities; reduce carbon emissions by achieving a modal shift of freight from road to rail; and provide an attractive alternative to flying for longer journeys within the UK. At the regional and local level, rail services should be integrated with other modes, as part of a seamless public transport system. There should be a strong ethos of public service, in which all staff feel they are working to create the best possible railway, for the benefit of all of us.

How the railway is structured in other countries

Elsewhere in Europe, between 80% and 100% of passenger train services are provided by the public sector. Publicly owned companies also carry the majority of rail freight in most other European countries, excepting the Netherlands.

Other European countries provide important lessons for reform in the UK. Generally, the publicly-owned train operator has a 'semi-detached' relationship to the publicly-owned rail infrastructure manager. This may take the form of two separate state-owned companies (Spain, France, Sweden, Netherlands); separate companies within a state-owned group of companies (Germany, Italy); or divisions of a single state-owned company (Switzerland). The European Commission is challenging the way some countries have transposed EU rail directives into domestic law, but although this may lead to some limited adjustments, there is no prospect of any of these countries having to abandon their basic railway structures.

Other countries accept that rail infrastructure requires state financing, planned over periods of multiple years (typically 3-8 years), and in the context of a longer-term (15-20 year) overall plan. Regional governments in all other European countries (and Switzerland) have a major role in the provision of local rail services, even if local trains are operated by the national state-owned train company with funding derived from national budgets. Other European countries have been more successful than Britain at sustaining domestic train manufacturing.

Unifying passenger train operations in Britain at minimal cost

Gradual acquisition of passenger franchises would not require significant public expenditure. Train operating companies could be absorbed into a public 'passenger operations' organisation as existing franchises expire; through tighter enforcement of franchise conditions; as TOCs themselves choose to surrender franchises; or as their premium payment structure reduces their purchase value to zero or a minimal price. Despite the planned move to longer franchises, break points to review performance may offer an opportunity to bring under-performing franchises back into the public sector.

Bringing passenger operations back into the public sector in a gradual way would provide a comparator against which the performance of other operators could be benchmarked. While some of our expert interviewees preferred bringing passenger operations entirely within the public sector, and others favoured a 'mixed economy' with some continued private sector involvement, it is notable that the first step – taking some passenger franchises back under public control – is the same. Our proposed gradual approach offers a means to build a consensus over time, through measurement and comparison of the performance of private and public operations.

Inter-city services within a unified passenger train operator

Most countries' rail systems show a clear structural distinction between fast long-distance inter-city services, and more local trains serving a single city or region. Our expert interviewees felt that fast long-distance services should be reassembled as a single management and business unit, forming a strong flagship 'brand' for the reunified railway. Public operation of these potentially profitable services would bring advantages to the public purse and to passengers. The Government could choose to direct the resulting profits towards reducing fares on long-distance rail routes, which

would help cut motorway congestion and carbon emissions; or to cross-subsidise socially valuable services on other routes.

The role of regional bodies and devolved administrations in relation to passenger services

Within the context of a unified passenger operator throughout England, Wales and Scotland, there was support from expert interviewees for regional bodies and devolved administrations to play a greater role in specifying the service needs of train passengers within their catchments; negotiating with the unified passenger operator to deliver those services; and arranging integration between local rail services and bus, tram and tube services. Funds for local and regional passenger rail services should flow via regional bodies and devolved administrations.

An overarching 'guiding mind' for the railway: 'GB Rail'

The need for the different parts of the railway to be managed as a coherent whole arose repeatedly in our discussion with experts, several of whom pointed to the need for a 'guiding mind' to ensure that services, infrastructure and rolling stock are managed and developed in an integrated and consistent way.

While EU law poses certain constraints on how such integration may be achieved, a careful assessment of the structural arrangements in other EU countries, and the specific grounds on which the European Commission has challenged these structures, suggests that substantial integration under an overarching 'guiding mind' would be possible.

This 'guiding mind' body, which we term 'GB Rail', would provide a single railway entity for a national Government to deal with. Because it would have an overview of the whole railway, it would be able to achieve efficiencies that are not currently possible. 'GB Rail' would be a publicly-owned corporation, with a subsidiary company responsible for passenger train operations and certain functions relating to infrastructure (maintenance and enhancement, signalling and station management), which we term 'GB Rail Network and Operations', and a separate subsidiary company responsible for capacity allocation and access charges, which we term 'GB Rail Access'. It would also be responsible for any publicly-owned freight operations. This structure appears compliant with EU law, as the 'essential functions' relating to non-discriminatory access for privately-owned freight operators and international passenger operators would be managed independently of the publicly-owned passenger train operator. Within GB Rail Network and Operations, it would be necessary for passenger operations and infrastructure divisions to operate with independent accounting, in order to fulfil EU regulations.

Our review of the structure of the railways in other European countries did reveal a variety of other ways of achieving the important 'guiding mind' function that is currently absent in Britain, and suggested that the proposed model was not the only possible choice. However, most alternative structures appeared more difficult to defend against challenge from the European Commission. This does not make them completely unfeasible: a determined Government could decide to fight the European Commission in order to achieve its preferred structure, and if necessary to pay fines, which would be small in comparison to the cost savings from public ownership.

Reform of Network Rail

There would be several benefits from making Network Rail a division or subsidiary of a publicly-owned 'guiding mind' organisation. First, it is estimated that over £150 million of debt interest payments could be saved every year by bringing Network Rail into the public sector. Second, weaknesses in Network Rail's current governance structure could be addressed, making it properly accountable to government for the public money that it spends. Once its 'essential functions' of allocating and charging for network capacity were hived off to GB Rail Access, Network Rail could gradually take on a train operations role, becoming GB Rail Network and Operations. Thus it would not be necessary to set up an entirely new public body to absorb passenger operations as these were brought back into the public sector.

The present five-year planning and finance cycle for rail infrastructure investment should be retained, within the context of a new longer-term strategic rail plan which would be the outcome of a political process to agree a vision for the future of Britain's railways. This would address strategic issues such as how inter-city services should be developed outside London.

A new model for rolling stock procurement

'GB Rail' should be able to procure new trains directly, using either government grant or government-backed debt. It would be able to plan a regularised programme of procurement to meet predicted rolling stock needs and strategic plans for the future of the railway, offering better value for money than the current arrangements. Savings could be enhanced by standardising stock across the UK instead of adopting different specifications for various routes, franchises and TOCs. An approach to procurement which supported UK train manufacturing industry could be consistent with EU legislation, if it was appropriately framed.

Fair lease costs for existing rolling stock

It is important to overcome the longstanding problem that ROSCOs are able to charge excessive rents for their trains, in a market where there is very little effective competition. Control of lease rentals could offer an effective tool to ensure existing rolling stock is available at a reasonable price. A new Government could propose a reduction in lease rentals in return for a usage guarantee on the ROSCOs' stock, and, if no agreement were reached, it could introduce regulation to control lease rentals, with an independent expert determining a fair price for the remainder of the life of the stock.

A growing rail freight sector

The context for reforms to improve rail freight is different to that for passenger operations because competition in this sector is required under EU law. Since any freight operator who was bought out is guaranteed a right under EU law to re-enter the UK rail freight market, it is unclear what purchase might achieve. The private freight operators are profitable companies and therefore could also be expensive for the Government to purchase.

DRS, which is publicly-owned, could become a division or subsidiary of 'GB Rail', and this would be consistent with EU Rules.

Growth in rail freight would be aided by greater investment in strategic freight network infrastructure schemes. Some schemes which are presently unaffordable

could become viable if more rail enhancement projects were carried out by Network Rail's own workforce rather than being outsourced.

Implications for rail regulation

Although no independent rail regulator existed before privatisation, it is likely that the Office for Rail Regulation would need to be retained, with modified terms and powers. Its role would include overseeing access arrangements to UK railways for private freight services and international passenger services through the channel tunnel. It might be responsible for ensuring a fair price was paid for the lease of existing rolling stock from the ROSCOs; and might also oversee the setting of track access charges for different freight flows and their fair application to freight operators in the private and public sectors.

The political programme for railway reform: now and from 2015

A Labour Party that was committed to reform of the railways could take some important steps now, in preparation for action as a future Government. These include stating that no new franchises will be signed under a Labour Government; stating that an incoming Labour Government would review all existing franchises to assess whether tax-payers and fare-payers would receive better value-for-money from an immediate buy-out of certain franchises; and arguing now for break-points in all longer franchises let under the current Government, to allow for review including termination.

To reduce leakage of public money out of the railways, the Labour Party could propose a 50% tax on all dividends paid by TOCs and ROSCOs. It could also state that in Government it would regulate the ROSCOs' oligopoly to ensure a fair price is paid for lease of rolling stock.

These steps could be taken in the context of an overarching Labour Party strategy to Rebuild Rail, which could include commitments to make the UK railway system as integrated as possible within the constraints of EU law; to bring fares more into line with those in Europe; to eliminate leakage of public monies out of the railways; and to develop the railway's potential to contribute to Britain's prosperity.

1. Introduction

The Rebuilding Rail project was initiated by Aslef, RMT, TSSA and Unite, to examine how the railways could be restructured to the benefit of both passengers and taxpayers, in order to inform decisions about the future of the railways that will face a future Labour Government.

The context for the project is a widespread concern – shared across the political spectrum – that we are not getting good value from the substantial sums of public money that are invested in the railways every year. This led the previous Labour Government to commission the McNulty rail value for money study. McNulty's findings confirmed that the cost of our railways, compared, for example, to other railways in Europe, is higher than it should be. But his recipe for reform is essentially superficial, and unfit to tackle what many observers now see as a fundamental structural problem: that the complex privatised railway structure created by the Conservative Government in 1994 inevitably resulted in fragmentation, creating an inefficient system with legal, administrative and bureaucratic costs at every interface. There is also the issue that much of the money we put into the railway, through government grants and passenger fares, now leaks straight out. The privatised railway is very profitable for some: the banks that bought the rolling stock companies at knock-down prices; the parent companies that took the profit from the railway as dividends in the good times, but walked away from their franchises when times were less good; the chief executives who enjoy seven-figure remuneration packages. This unfair profit is at public expense.

This analysis of the defects of the current system is not new. But diagnosing the problem is, in a sense, the easy part. The difficult questions are about what new structure would work better; how a Government committed to reform might create such a structure without great expense and upheaval in the process; and whether perceived obstacles to reform – notably EU legislation – are indeed a barrier to creating an integrated railway system. These are the questions that this report seeks to address.

In setting out to answer these questions, we have carried out structured interviews with over 20 experts with deep knowledge of the railways, in order to gain their insights as to how we might make Britain's railways work better. The project has involved a comprehensive review of the academic and professional literature on the effects of privatisation on Britain's railways. We have also looked at how other countries run their railways, and what lessons can be drawn from that experience.

The report is organised in two halves.

Part I of the report is a review of the problems with the current structure of the railways and the difficulties in achieving change. It examines:

- The high cost of the current structure
- How the current structure affects passengers
- How the current structure affects freight
- How the current structure has damaged our rail manufacturing industry
- The perceived obstacles to reform.

Part II then sets out how these problems may be overcome. It looks at:

- A vision for the future of Britain's railways
- How reform would enable a more integrated transport system
- How reform would offer the potential for a resurgent rail manufacturing base
- Lessons from other countries
- Choices for how to reform our railways, and how these could be achieved
- Action that political parties can take, both now and after the next election.

Part I: The problem

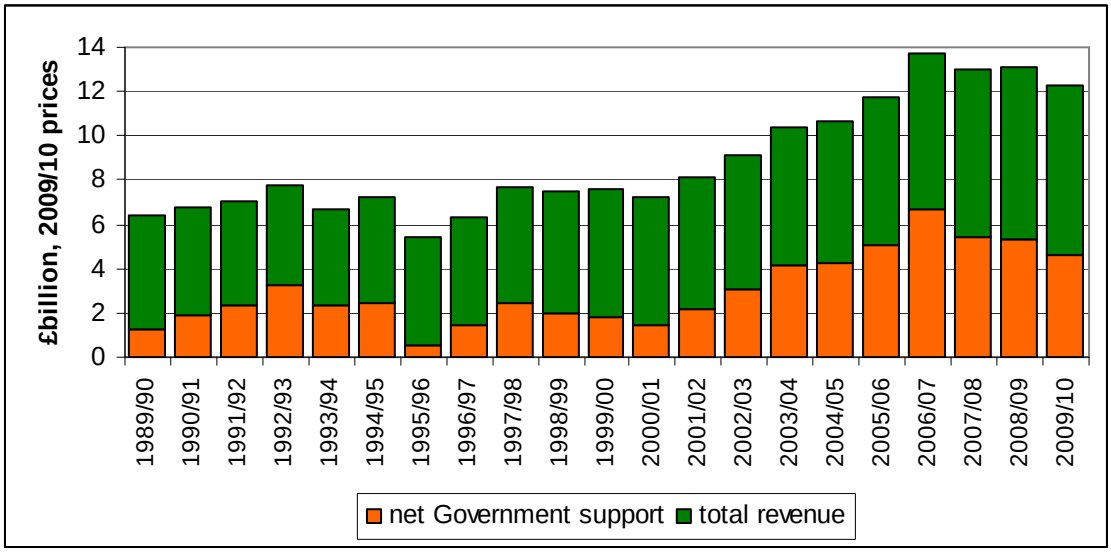
2. The cost of the privatised railway

2.1 Overview of increased costs since privatisation

Since privatisation, the cost to the public purse of running the railways has risen very substantially. This is directly counter to the declared expectation of the Conservative Government at the time of rail privatisation, which, in 1992, suggested that rail privatisation would reduce waste and otherwise reduce costs, and that this would eventually lead to net receipts to the public purse as a result of franchisees running profitable services[2].

Estimates of the magnitude of the increase in cost vary, with different commentators suggesting that costs have increased by a factor of between two and three times. The most cautious view would be that net Government support to the railways has more than doubled in real terms since privatisation (from approximately £2.4 billion per year during the five-year period 1990/91-1994/95, to around £5.4 billion per year during the period 2005/06-2009/10, all at 2009/10 prices). Over the same period, money going into the railways from passenger fares and freight charges has also increased, such that the combined total of Government support and passenger and freight revenue has similarly nearly doubled, from about £7 billion per year to nearly £13 billion per year (again, at 2009/10 prices), as shown in Figure 1[3].

Figure 1: Government support and passenger/freight receipts



Source: McNulty R (2011) *Realising the potential of GB rail*, *detailed report*

> *"The state is putting an awful lot in. If British Rail had the same funds now we'd have a gold-plated state railway."*
>
> John Stittle, Senior Lecturer in Accounting, University of Essex

Supporters of the privatised railway have argued that there are some underlying reasons for these cost increases, and that they are not a consequence of privatisation itself. Certainly it is true that a proportion of the increased cost may be attributed to a growth in the number of services operated. In the period since privatisation (between 1994/95 and 2005/06-2009/10), timetabled train kilometres on the national rail network grew by 33%[4]. It may also be argued that part of the increased cost of the railways in recent years is due to greater investment in upgrades of track and other infrastructure, following a period of under-investment,

poor project management and inadequate cost-control during Railtrack's ineffective stewardship of the rail network.

However, these factors cannot account for the real-terms doubling in the annual cost of the railways since privatisation. The railways are not twice as good now as in the early 1990s. For example, the length of electrified route in 2010/11, at 5,262 km, is basically unchanged since 1994/95 (when it was 4,970 km)[5], and the last period of significant electrification of the railway network was in the late 1980s.

2.2 Non-productive increases in cost

A number of rail analysts and experts have identified other reasons for the increase in the cost of the railways since privatisation[6]. These include higher interest payments in order to keep Network Rail's debts off the government balance sheet; debt write-offs; costs arising as a result of fragmentation of the rail system into many organisations; profit margins of complex tiers of contractors and sub-contractors; and dividend payments to private investors. Our review of the literature suggests that, taken together, these represent a cumulative cost since privatisation of more than £11 billion of public funds, or around £1.2 billion per year. Those costs which may be most readily quantified are summarised in Figure 2 and described below.

To put these figures in context, if all unnecessary costs were eliminated and the resultant saving was entirely used to reduce fares, it would equate to an across-the-board cut in fares of 18% (or a substantially larger cut in fares that are price-regulated because of their social importance). Any cut in rail fares would be extremely popular. An opinion poll survey in October 2010 found that 80% of voters opposed the current Government's plans to allow rail fares to rise faster than inflation, and this was the single most unpopular policy announced in the spending review[7]. Another poll (also October 2010) found that 74% of rail commuters in the South-East said they could switch their support away from parties that raised fares[8].

Figure 2: Quantifiable costs of privatised and fragmented railway system

	Annual (£ million)	Cumulative (£ million)
TOTAL COSTS	**£1.2 billion**	**£11.3–11.7 billion**
Excess interest payment on Network Rail debt[9]	156	950
Fragmentation costs		
Cost of interfaces between TOCs and Network Rail[10]	290	not known
Network Rail: cost of outsourcing renewals / enhancements (and maintenance before 2003/04)[11]	200	2311
TOC sub-contractors' operating margins[12]	76	771
ROSCO sub-contractors' operating margins[13]	15	176
Leakage		
Dividend payments: Railtrack[14]	-	709
Dividend payments: TOCs[15]	227	507-1000
Dividend payments: ROSCOs[16]	207	2520
Sunk costs		
Underselling of ROSCOs at time of privatisation[17]	-	1100
Debt write-offs and liability transfers to make Railtrack sell-off attractive[18]	-	2208

The quantifiable costs summarised in Figure 2 include:

Excess interest payment on Network Rail debt

Because Network Rail is a private company (albeit a not-for-dividend company), it pays a higher rate of interest on its debt than would be payable if it were part of the public sector. The additional interest payments as a result of this difference between private and public sector borrowing costs have been put at £156 million in 2009, with a cumulative figure of £950 million since privatisation (over the period 1997 – 2009)[19]. Network Rail was set up as a private company precisely in order to keep its debts off the government balance sheet, so as not to contravene the Treasury's so-called 'sustainable investment rule' on the ratio of government debt to GDP. In practice, however, the off-balance sheet nature of Network Rail's debt is a fiction, as the government is ultimately responsible for it. Before privatisation, in 1993/94, British Rail had a debt of £2.5 billion. This increased under Railtrack to £6.9 billion. Debt was not brought under control by the transfer to Network Rail, and increased further to £22.3 billion in 2009, incurring interest payments of £1.1 billion in that year[20]. Interest payments on debt represent a substantial proportion of the public money paid to Network Rail each year. For example, over the period 2004-2009, interest payments represented 48% of the total public subsidy for Network Rail[21]. The excess cost of servicing Network Rail's debts will increase in line with its growing debt burden if it remains as a private company.

Cost of interfaces between train operating companies and Network Rail

Research by Oxera for the McNulty review of rail value for money estimated that the cost of interfaces between train operators and Network Rail was substantial, and put it at about 5% of TOC costs. TOC net costs (excluding Network Rail access charges but including ROSCO charges) were put at £5.8 billion in 2009/10, which suggests

that interface costs between train operators and Network Rail are about £290 million per year. As one example of an inefficiency giving rise to extra costs, Oxera reported that 300-500 people are employed at Network Rail and operators for delay attribution, a process sufficiently involved and complex that the delay attribution guide comprises 90 pages[22].

Cost to Network Rail of outsourcing renewals, enhancements and maintenance

Until 2003, Network Rail's track maintenance work was outsourced to contractors. The high cost of this arrangement led to a decision to progressively bring maintenance work back in-house. This resulted in substantial savings, which were put by Iain Coucher, Chief Executive of Network Rail, at £264 million per year[23]. Other estimates for the magnitude of these savings range from £100 million to £400 million per year[24]. However, more major work – renewals and enhancements – is still outsourced, and this accounts for over 70% of infrastructure expenditure. It has been suggested that contract profit margins on renewals and enhancements are over £200 million per year[25].

TOC and ROSCO sub-contractors' operating margins

Both the TOCs and the ROSCOs employ sub-contractors, each of which must make a profit on its activities. Research by Just Economics[26] estimated the operating margins of sub-contractors working for the TOCs and ROSCOs. These were £76 million in 2009 (with a total of £771 million over the period 1997 – 2009) for the TOCs; and £14.5 million in 2009 (with a total of £176 million over the period 1997 – 2009) for the ROSCOs.

Dividend payments to Railtrack shareholders

During the period between 1995/96 and 2000/01 when it went into administration, Railtrack paid dividends to its shareholders of £709 million. After this date, the new not-for-dividend structure of Network Rail meant that this form of leakage of money out of the railways ceased.

Dividend payments to TOC shareholders

Estimation of the dividend payments made to shareholders as a result of profits by train operating companies is not straightforward, because company annual reports for the main transport operators do not disaggregate profits for train operations from those for bus or international operations. In 2009, dividend payments from the 'big five' transport operators (Arriva, First Group, National Express, Go-Ahead and Stagecoach) totalled £227 million. Over the period 1997-2010, research by RMT found that the same operators had paid total dividends of £2.1 billion, of which they suggested at least half (i.e. at least £1 billion) arose from profits in their rail operations[27]. Other estimates are somewhat lower, but broadly consistent[28].

Dividend payments from ROSCOs to their parent companies

Since privatisation, the ROSCOs have made dividend payments to their parent companies totalling £2.52 billion (covering the period from 1996 until 2009). The amount paid varies considerably from year to year, but was £207 million in 2009[29]. There have been repeated complaints that the profits made by the ROSCOs are unfair. According to the National Audit Office, the leasing charges paid by a TOC to a ROSCO for a new train will pay the cost of that train within seven years, but the TOC will continue to require subsidy to cover leasing costs for the remainder of the life of the train, which is at least 30 years. Consequently, the train leasing business is very profitable: one study found that operating costs represented only somewhat over half

(59%) of the ROSCOs' income in 2004, leading to a profit before tax and interest of 41% of their income in that year[30].

Underselling of ROSCOs at time of privatisation

The three ROSCOs were sold off in January and February 1996 for a total of £1.8 billion. However, by the end of 1997 their value had soared and all three had been sold to new buyers for £2.7 billion, an increase of 50%. The NAO concluded in March 1998 that taxpayers had lost £1.1 billion over this sale, and that the Government was at fault in failing to include a clawback provision in the terms of the sale[31].

Debt write-offs and liability transfers to make Railtrack sell-off attractive

In order to make Railtrack's flotation attractive to prospective shareholders, the government wrote off debt of £1.5 billion and introduced new debt of only £586 million (which was subsequently reduced by £225 million to allow Railtrack to finance Thameslink 2000). It also transferred liabilities of £1 billion for the upkeep of 1000 bridges to local government. A privatisation dividend was also paid to shareholders, costing £69 million, and paid for from surpluses while the company was still in the public sector[32].

These are only the readily-quantified costs of rail privatisation, but our literature review also revealed many more costs which are difficult to quantify: excess interest payment on ROSCO debt; poor cost control; excessive bonus payments and high salaries for senior managers; costs of bidding for franchises, awarding them, and re-branding when a new company takes over; bail-outs and defaults of failing operators; unplanned costs arising from over-complexity; the cost of 'feast-famine' procurement; and tax not paid. These are summarised in Figure 3.

Figure 3: Other factors increasing the cost of the railways

Excess interest on ROSCO debt	Annual interest payments on ROSCO debt are between £127 million and £203 million (figures for 1997 – 2004), at commercial rates of interest[33]. Leasing trains (effectively hire-purchase) is significantly more expensive than buying them outright, and also more expensive than procuring trains via government-backed debt.
Inadequate cost control	Some academic analysts have concluded that project management capacity in Network Rail is unequal to the complex task of organising many layers of contractors and sub-contractors, leading to poor cost control and wasted expenditure. One study for the Office of Rail Regulation found that of 798 renewal projects, only just over 60% were fully justified[34].
Excessive bonus payments and high salaries for senior managers	CEOs of TOCS and Network Rail typically receive remuneration packages of £640,000 - £1.35 million per year, comparable to typical annual earnings of a FTSE mid-250 CEO. A reintegrated railway would require fewer chief executives, and would offer remuneration that was more in line with other public sector salaries, which are typically 10-25% of those of a FTSE mid-250 chief executive[35]. The criticism in early 2012 of the proposed remuneration package for Network Rail directors could equally be applied to other CEOs in the rail industry, as all are effectively paid for in part by public money.
Cost of re-letting each franchise	The cost of bidding for each franchise has been estimated as £3 – 5 million per TOC, and the cost of DfT managing the franchising process is put at £2.5 million per franchise awarded, giving a typical cost of a franchise award with just three bidders of £11.5-17.5 million. There are also substantial start-up costs for each new franchise, put by TfL in evidence to the Transport Select Committee at £2 – 5 million[36].

Bail-outs and defaults of failing operators	When franchises run into difficulties, there may be substantial unanticipated costs in order to bail them out, or to secure a transfer of the franchise to another body. The bail-out of Connex South East, shortly before the withdrawal of its franchise in 2003, cost £58 million. The MTL group was nearly bankrupted by losses on Regional Railways NE in 2000, and was bailed out by another operator, Arriva, which was given an additional £55 million in subsidy by the Government. More recent defaults on the East Coast franchise, first by GNER and then by National Express, mean that anticipated premium payments to the Government have not materialised, despite GNER making substantial profits (which were remitted back to its parent company in the form of dividends) in the early years of the franchise. Neither company faced a significant penalty for default on the East Coast franchise and failure to make these payments[37].
Unplanned costs	The sheer complexity of the structure of the railway generates additional costs. For example, a National Audit Office report in 2004 into the process of commissioning new trains found that there had been an unplanned additional subsidy of £760 million from the SRA to four TOCs to offset costs associated with new trains they had been required to commission which turned out to be unreliable; further subsidies to the TOCs to cover the cost of mothballing new trains until the infrastructure had been improved; and additional costs associated with leasing replacement trains[38].
Cost of 'feast-famine' procurement and uncoordinated specification	Bombardier suggested in evidence to the Transport Select Committee that 'feast-famine' procurement increases the cost of building trains. New trains are sufficiently complex and innovative that during production of a particular design there is considerable potential for 'learning' of how to optimise the production process. If the same number of vehicles were produced over a longer timescale, rather than in one batch, production systems could be improved after building the first units to capture efficiencies and iron out problems. This would save an estimated 10% of the cost of any given order. Bombardier also comments that 'feast-famine' procurement and the resultant fluctuations in manpower requirements mean human misery, an industry unappealing to graduates, and the disappearance of technical training apprenticeship schemes[39]. Added costs also result from the absence of any strategic leadership to standardise designs across the network, resulting in expensive bespoke manufacture rather than economies of scale.
Tax not paid	In the period 2002 to 2006, the TOCs and ROSCOs paid tax at a rate which fell from 18.7% to 7.9% (and was just 3.8% in 2005), at a time when the headline UK corporation tax rate was 30%. Over this four year period, £731 million was not paid as a result of the low tax rates the industry enjoyed. There has been no estimation of the amount of tax not paid since 2006[40].

2.3 Wider social, economic and environmental costs

The costs associated with fragmentation and leakage of public money out of the railway translate into social costs. A portion of the public monies allocated for investment to increase the railway's capacity and to improve services has instead been diverted to provide private profit. That money could have been spent on tackling overcrowded commuter trains and run-down stations, and re-opening missing links to make the railway work better. Instead, we have more unpleasant commuting, more dysfunctional cities, and rural isolation.

Leakage of money out of the privatised railway system has also reduced the amount that can be invested in rail improvements to stimulate economic activity and

regeneration. This represents a lost opportunity. For example, there is evidence that towns that lack good transport links to their nearest main city are falling behind economically: research by the Centre for Cities showed that poor train services were resulting in a widening 'wealth gap' between such towns as Burnley and Blackburn and Manchester[41]. There are sizeable towns lacking rail links which could benefit from reopening rail lines and stations to attract economic investment and offer residents access to more work opportunities[42].

> *"Rotherham has a bad train service but it could be a lot better, but nobody has ever thought of it. Barnsley is the same I think. We should look at railways as a renovating force. The railways traditionally created wealth and that's something they could still do."*
>
> Christian Wolmar

Even where new investment takes place, there is a sense that the present system prevents regions reaping the potential benefits.

> *"Look at Liverpool to Manchester, two major cities – the passenger services are diesel trains. We've been promised electrification between Liverpool and Manchester, but the rolling stock will be the old electric units that are now on Thameslink. They are already 21 years old. These units will be 26, 27 years old when they come here! If this was France, Germany, Spain and they were putting up new electric wires between two major cities, they'd put on brand new electric trains to use them."*
>
> Mark Dowd, Chair, Merseytravel

The railways also have an important role in reducing carbon emissions, especially for regular commuter trips, long-distance inter-urban trips and long-distance freight. But if they are to play this role and successfully compete against other modes of transport, we need to increase rail capacity and decrease journey times, through more train carriages and enhancements of the railway network, and we need to invest in electrification and designing and building lighter, more efficient trains. All these investments are more expensive under the current cost structure of the railways.

The present Government policy, which seeks to recover an increased share of the excessive cost of the privatised railway from passengers, is set to cause greater, rather than less environmental damage. Higher rail fares will force passengers to switch from rail to driving, increasing carbon emissions. Since privatisation, the real cost of train travel has risen by 17% in real terms, while the real cost of motoring has fallen by 7%[43], and higher fares will widen this gap.

2.4 What might justify such a cost-inefficient structure for the railways?

What possible advantages might justify such a cost-inefficient structure for the railways? Supporters of rail privatisation make two arguments: first, that competition leads to greater efficiencies; and second, that the private sector brings investment and innovation.

We examine these arguments in greater detail in Sections 6.2 and 6.3. But it is worth noting here that fragmentation and franchising of train services has resulted in little real competition, and just three large transport groups either own or hold more than 48% of shares in the operators of fourteen passenger rail franchises in the UK[44]. A large part of the outgoings of a TOC takes the form of charges to Network Rail and

leasing charges for rolling stock, with the ‘true variable costs’ being put by one train operator in evidence to the Transport Select Committee as about 6-11% of the total cost base. It is perhaps therefore not surprising that there is little incentive to run a more efficient railway[45].

There is little evidence that the privatised structure of the railways has generated substantial private investment. Parent companies of the special-purpose vehicles that have been set up to bid for franchises have extracted money (in the form of dividends), rather than investing it. This is hardly surprising, since there is little incentive to invest for the long term in a franchise that may be relinquished in a few years’ time.

Specific examples of private sector innovation are also hard to track down. When the Transport Select Committee asked train operators to provide examples of their innovative advances, it found just one example of what it termed ‘real’ innovation, which involved a timetabling solution for trains between London and Ipswich that delivered six trains per hour instead of five[46]. In practice, the very detailed and specific contractual requirements of franchises limit the scope for innovation – and yet such detailed contracts are necessary and unavoidable under the current system.

3. How the current structure affects passengers

3.1 High cost of travel

For many ordinary people the high price of tickets – in part a function of the extra costs caused by privatisation and fragmentation – renders rail travel unaffordable, and for others it is a greater cost burden than it should be.

As things stand in the UK, the railway is in danger of being a mode of transport available only to the better-off, or, in the striking turn of phrase of former Transport Secretary Philip Hammond, "a rich-man's toy"[47].

Britain has Europe's highest commuter fares for both day returns and season tickets; and for the price of a completely restricted advance purchase ticket in Britain a passenger could generally get a fully flexible ticket in other European countries, as shown in Figure 4[48]. This situation is set to get worse under current Government policy.

Figure 4: Average fare costs in the UK compared to other European countries

					pence per kilometre
	Day Return	Restricted Day Return	Season Ticket	Long Distance	Advance Long Distance*
UK	**26**	**17**	**14**	**49**	**15**
Germany	17	17	8	28	13
Switzerland	15	14	4	39	18
Netherlands	13	12	8	34	20
Sweden	13	13	6	21	10
Italy	12	11	4	22	10
Spain	9	9	7	24	16
France	8	8	8	15	6

* journeys to/from the first city
Source: Just Economics (2011) analysis of data from Passenger Focus (2009)

Despite these high fares, overcrowding is an increasing issue for train travellers. In the absence of any legal loading limit for passenger carriages, there is no effective pressure on TOCs to stop them working trains in 'cattle class' conditions to achieve higher profits. The 2012 Command Paper on rail[49] appears set to add further insult to this injury by introducing ultra-peak fares for passengers travelling at the busiest times. This will not only increase fares but will add increased complexity of fares to a rail system that is already hugely confusing to most travellers, as discussed in the next section.

3.2 Complexity of the system

Ticket purchase for anything but a straightforward journey with a single train operating company is excessively complex. The first result of Britain's fragmented pricing structure is that it is often uneconomical to take the convenient option of simply buying a return ticket. Instead, unless they are oblivious to cost, prospective travellers must spend considerably longer to try to purchase cheaper singles. However, for many journeys a reasonably inexpensive fare can only be obtained by

further splitting each leg of the journey into different sections according to the operations of different train operating companies and buying separate single tickets accordingly. Where different train companies overlap over certain sections of track or run on parallel routes the options multiply disconcertingly (Figure 5). If the purchaser does succeed in working out the possible geographical variations they are then faced with finding and comparing for each one the different ticket prices for different times of train. This whole process consumes a great deal of time and even at the end of it the buyer is not sure they have obtained the cheapest deal.

In practice, most people do not put themselves to this trouble. Some resign themselves to paying over the odds, but many have simply concluded that they do not have the time, determination and esoteric knowledge required to find a reasonably-priced rail ticket – not to mention the ability to buy far in advance having committed to a cast-iron schedule fitted to the inflexible ticket. Instead they decide that their car is the only affordable or feasibly convenient option. This is directly contrary to government policy that has long-since recognised the imperative to achieve more travel on sustainable modes of travel such as rail.

Figure 5: Complex ticketing as it affects passengers

Example 1

The best ticket from Newtown Powys to London could be any of the following train company/cost variations:

Change from Arriva Trains Wales to Virgin Trains at any station between Wolverhampton and Birmingham International (each different total cost).

Change at Wolverhampton for Arriva CrossCountry to Stafford and thence to London Euston (another cost).

Change at Birmingham New Street for a London Midland service to London Euston, or for a Chiltern Railways service from adjacent Birmingham Moor Street to London Marylebone (both slower but sometimes much cheaper).

Example 2

One of the authors wished to travel to a wedding in the Yorkshire Dales close to the railway line between Settle and Carlisle. In terms of travel distance the journey was little different travelling via Settle or Carlisle, but the most convenient option was to go via Carlisle and return via Settle. However, no return ticket was valid for both the train companies involved in the outward route and the train companies involved in the return route. Despite the best efforts of a ticket clerk who spent over 30 minutes trying to find cheap options the only possibility was three single tickets amounting to £150, almost double the price of a return ticket.

3.3 Lack of clear accountability

The market-driven interfaces between different train companies, and between train companies and Network Rail, can leave the traveller stranded in the middle.

For example, if one train operator incurs a delay for technical or other reasons, other train operators feel no duty to connecting passengers to so much as minimally adjust services, even for those booked on pre-booked through tickets, or where a train missed by seconds will result in several hours delay (Figure 6).

Similarly, the confrontational financial-legal nature of the interface whereby Network Rail imposes engineering track closures on the TOCs apparently allows of no overview that ensures the passenger will receive an acceptable alternative service. In some cases engineering works shovel passengers from one TOC onto another without any transfer arrangement in place so travellers receive the insult of added cost in addition to the injury of inconvenience

Figure 6: Passengers left stranded between rival train operators

Example 1

One expert interviewee for this project holds a season ticket from Northampton to London. An unforeseen problem cancelled services without warning on a day when he had urgent work in London. Fortunately, a parallel line runs to London via Wellingborough, which lies to the northeast. The logical way for an integrated railway to look after its marooned passengers would have been to provide bus transport to get passengers to this parallel line (which, from the experience of the interviewee, would probably have been the response of British Rail). But the parallel line is now operated by a competing train operating company, so tickets from one line are not valid on the other. By resorting to a taxi to Wellingborough (£26) and purchasing a valid standard class ticket from there to London (£49.50) our interviewee succeeded in fulfilling his work engagement. He submitted a claim for reimbursement, further aggravated by 1 ½ hrs additional delay on the way home. After taking ten weeks to consider his claim, the train company responded with an offer of just two pounds. The interviewee concluded: 'This structure is not for passengers, it's for investors. The passenger is getting screwed'.

Example 2

During autumn 2011, Network Rail shut the line between Shrewsbury and Birmingham for engineering works on Sundays. Trains from mid-Wales were therefore diverted at Shrewsbury to Crewe in order to allow a satisfactory change for travellers bound for London. However, these travellers were charged nearly £10 more than the usual ticket price because Virgin Trains travelling from Crewe to London would not accept the standard tickets issued by Arriva Trains Wales via Birmingham, despite the fact that the standard tickets would also normally entail use of a Virgin train from Birmingham onwards. The net result was that passengers were charged more for the inconvenience that the railway was causing them.

These problems for passengers are a direct result of fragmenting the railway to enable privatisation. Competitive and legalistic interfaces are intrinsic to the operation of a market to provide rail services. These bring considerable disbenefits to the rail passenger and moreover render impossible the sort of quality of service that the UK's still extensively interconnected network should be able to achieve. Many options for connections that could potentially be offered to the public within Britain's rail network are in effect ruled out.

Some defenders of privatisation claim that the privatised railway has brought a closer attention to customer service. But the complications arising from the competitive practices of TOCs make the railways much harder for the customer to use, and more expensive. The sandwiches may have got better, but the overall service feels worse.

4. How the current structure affects freight

4.1 The evidence: freight lifted versus freight moved

Amongst our expert interviewees, there were a variety of views on how the privatised structure of the railway has affected freight. Some observers of the railway, and one of our interviewees, argued that freight operations are more successful now than before privatisation. Others argue the opposite.

The latter days of British Rail saw freight being treated as a 'poor relation', and there is no dispute amongst experts we interviewed that British Rail oversaw a decline in freight during the late 1980s and early 1990s. However, the root cause of that decline is in issue, and freight experts who experienced this period pointed out to us that the decline was strongly linked to preparing the railway for privatisation. The drive to prepare freight for privatisation led a cut-to-the-core philosophy and discarded all but the most profitable freights.

It is significant to note that the decline in freight levelled out *before* privatisation, not after. Moreover, since privatisation the *tonnage* of freight ('freight lifted') has never reached the level of the late 1980's, for either non-coal freights or coal.

Achieving insight to the post-privatisation history of rail freight requires consideration of the two different ways in which rail freight is measured, because these two different measures of rail freight data tell quite different stories. 'Freight lifted' measures absolute tonnes of freight, whereas 'freight moved' measures tonne-kilometres – the weight of freight multiplied by the distance it is moved.

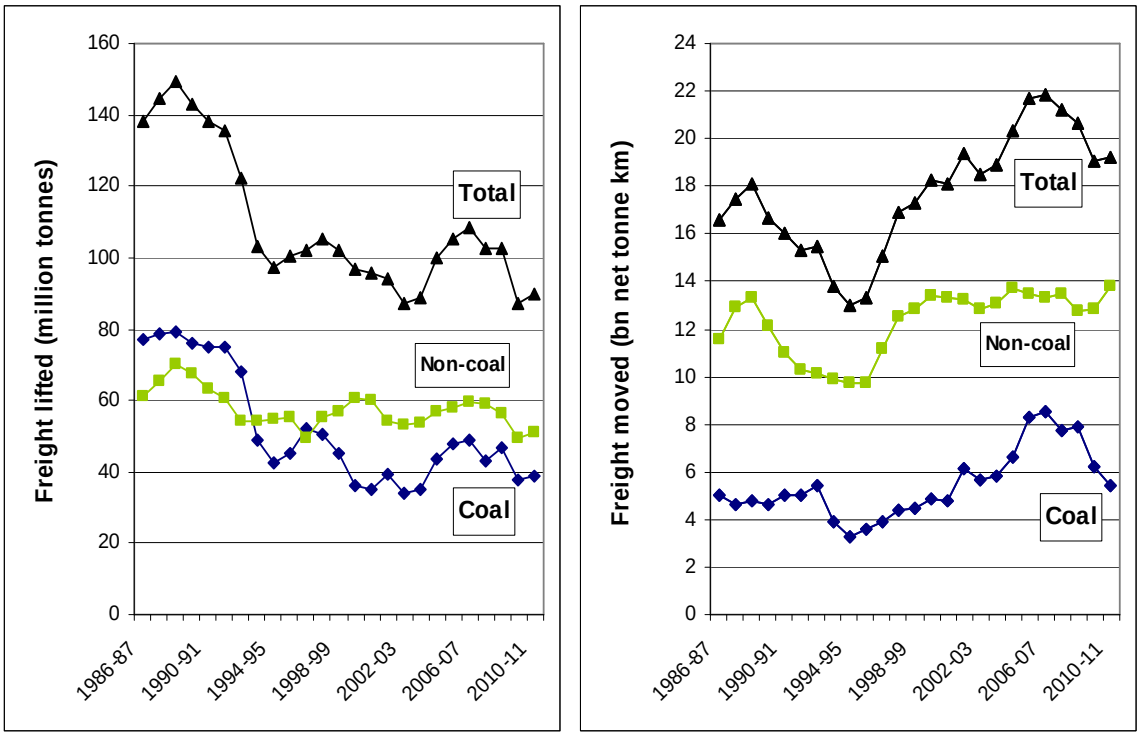
Figures for freight *lifted* show that the total tonnage of freight remains far below the levels of the late 1980s and since privatisation has been flat, or if anything, declined.[50] Defenders of privatisation tend to omit this statistic but instead point out that freight *moved* has risen. The disparity is a perverse consequence of the switch from domestic to imported coal, coupled with the way it is purchased, which has caused much the same volume of coal to make longer journeys from ports to power stations (Figure 7).

Once coal freights are stripped out it is evident that non-coal freight, measured as freight moved, does appear to show a bounce just after privatisation, although this can not be disentangled from the economic recovery after the recession of the early 1990s, and the trend has been strikingly flat since. However, viewed in terms of tonnes lifted (i.e. the actual amount of material moved) non-coal freights have tended to decline, and are presently lying significantly *below* the level before privatisation.

There is one encouraging trend in freight within the flat-lining total, and that is intermodal freight (i.e. containerised freight, including containers transferring to trains at sea ports) which has steadily increased, compensating for declines in some other freight categories. However, it would be wrong to attribute that success to the private freight companies. As one freight expert put it, *"That is nothing to do with privatisation, that's all to do with the rise of China and importing goods"* – that is, globalisation would have expanded this market anyway.

Looking more broadly at how rail freight has performed against its road-based competitors, it is equally important to note that privatised rail freight has not succeeded in winning an increased market share of the total tonnage of freight lifted. Rail freight market share of tonnes lifted was 4.7% in both 1999 and 2009, and lower in most years in-between.

Figure 7: Change in freight lifted and freight moved



4.2 Missed opportunities: how rail freight could have done better

Taken overall, the privatised rail freight industry might fairly be said to appear better than the rest of the privatised railway. However, there are lost opportunities in terms of what could have been achieved in the period since privatisation.

> *"Public funds have gone in for freight both directly and indirectly. The rail regulator cut track access charges for freight operators by £500 million in 2001 and they had a big programme of some £200 million in 2004 to increase the loading gauge in places. Well six years later there is no evidence for overall growth."*
>
> John Stittle, Senior Lecturer in Accounting, University of Essex

Leakage of public money out of the railway as a whole has reduced the funds available for investment in rail freight distribution centres; freight links to serve new industrial capacity; and expansion of the strategic rail freight network. This problem has been exacerbated by the high cost of out-sourcing rail enhancement projects to private contractors with the result that new works to increase freight capacity became prohibitively expensive.

Several interviewees felt that post-privatisation fragmentation of the railway and the resulting legalistic bureaucracy had created obstacles to the movement of freight, in particular reducing flexibility in train paths. This adds costs to all freight operations and may render some freight operations uneconomic. These difficulties constrain the growth of rail freight, which requires more, not less, flexibility in order to win market share against the flexibility offered by road hauliers. The 2012 Olympic site in London was cited as an instance where the fragmented system of private operators quoting individually for small loads had failed to offer the construction companies a competitive supply route; whereas a unified system would have been able to

organise coordination of loads with efficiently loaded trains that could have been cheaper than road transport and in addition offered environmental benefits.

One interviewee pointed out to us that the regulatory regime for freight has been very favourable, and that rail freight track access charges have been very substantially reduced over time, falling by 80-90% in real terms from the level immediately after privatisation, in an effort to stimulate growth in the rail freight market. Favourable track access charges for rail freight would be justifiable if they achieved rail freight growth, with its attendant social and environmental benefits. However, the savings in track access charges appear to have been captured as increased profits by freight operators, and as an unintended subsidy for coal-fired power generation, the most carbon-intensive part of the UK electricity generation mix.

Looking first at the capture of low track access charges by freight operators, one study found that over a period when track access charges for EWS (now DB Schenker) fell by £37 million the company profits correspondingly rose by £31 million, a 72% increase in profits despite just 1.8% increase in turnover. The author concludes that the company simply banked its reduced access charges rather than using them to win more trade for rail freight[51].

The dirtiest form of UK power generation, coal, has also been a major financial beneficiary of reduced freight track access charges. National Power, operator of half the UK's coal-fired power stations, including the biggest, DRAX, set up its own rail freight operation as a means to push down prices, and, once this objective had been achieved, sold off its rail freight business[52]. Coal consequently received a boost relative to the clean renewable forms of power that Government policies are supposed to favour. Thus favourable track access charges for freight, intended to help the environment by encouraging a shift of freight from road to rail, had the perverse effect of damaging the environment by subsidising the most polluting and climate-damaging form of energy production. Some of our interviewees saw a legitimate role for rail freight in supporting jobs in the coal-fired power generation industry, where this could be made more environmentally benign by coupling power stations with carbon capture and storage. However, any support for this objective should be specific, rather than a pricing structure that accidentally results in an incentive to burn coal regardless of whether its carbon emissions are captured.

5. How the current structure has damaged our rail manufacturing industry

5.1 The effect of the current system on manufacturing jobs

The UK's once successful rail manufacturing industry has been almost destroyed since privatisation. Immediately following privatisation there was an extended highly damaging hiatus in orders. The once publicly-owned British Rail Engineering Ltd suffered a succession of changes of ownership, passing through five owners and at least three changes of foreign parent management systems in the space of 12 years. This sabotaged any prospect of investment in new processes and design[53].

Most recently, the Government awarded a large contract for Thameslink trains to Siemens rather than the last vestige of BREL's train manufacturing facilities at Derby, now operated by Bombardier.

The Thameslink decision threatens a loss of 1400 jobs at Bombardier, plus an estimated 10,000 jobs in Bombardier's supply chain, affecting 825 sites around the UK[54]. A recent survey found that 41% of UK companies in the rail manufacturing supply chain are facing job losses as a result of the Government's decision, with SMEs facing the largest impacts on their businesses.

Other European countries have adopted a much broader view of the consequences of procurement decisions, with a long-term approach that not only factors in the strategic development of their rail system but also considers economic and social benefits of maintaining a domestic rail manufacturing industry.

> *"The [German] public authorities sometimes specify the type of rolling stock to support the domestic industry."*
>
> Dirk Schlömer, Divisional Director, Passenger Transport, EVG

5.2 The lack of a strategic approach to train procurement

A number of adverse factors have contributed to the catastrophic decline in train manufacturing in Britain since privatisation. Two major causes are:

- An overall level of investment that is, on average, too low to sustain manufacture
- A stop-start pattern of procurement that is lethal to maintenance of skilled staff levels and production facilities, both in the train manufacturers themselves and in their chains of smaller suppliers.

Both of these problems arise from the absence, since privatisation, of any kind of 'guiding mind' for the whole railway that is able to plan a sensible sustained procurement programme. Instead of a coherent vision for the future of the railway and a plan to meet it through steady, economical procurement from domestic suppliers, there has been spasmodic, expensive, uncoordinated procurement relying on foreign suppliers, whose research and development has been sustained by better strategic planning of the railway systems in their own countries.

Many of our expert interviewees pointed to the extreme inefficiency of having to take procurement decisions for new trains in ignorance of whether the lines they are intended to run may be electrified within the lifetime of the rolling stock in question, due to the absence of a strategic overview for the railway as a whole.

"Infrastructure development should determine procurement needs. But take the example of the IEP [Intercity Express Programme] rolling stock contract commissioning trains capable of running on either electric or diesel. That's a hugely costly way of procuring trains, but they did it that way because the future decisions on infrastructure had not been decided, so it wasn't clear what routes would be electrified and which would not."

Simon Weller, National Organiser, Aslef

The inadequate level of investment in train manufacture partly reflects the general leakage of monies out of the railway in the form of overly-high shareholder dividends. In this context it is relevant that, since the time of privatisation, the most pointed and persistent questions about excessive profits have been focussed on the rolling stock leasing system. For example, Angel Trains had a profit margin of 60% in the seven months to December 2010[55].

An underappreciated aspect of these astonishing levels of profit is the extent to which they undermine the case for public investment in new railway rolling stock. If public money supposedly earmarked for rolling stock appears to be bolstering ROSCO profits rather than providing the public with the benefit of new trains then it is much harder for politicians to argue for allocation of that money to the railways.

6. Perceived obstacles to reform

6.1 Key points

The idea of reuniting the railways under public control tends to draw objections that fall into three broad categories. The most common objections to reform run as follows:

- **Innovation, investment and efficiency:** Private sector companies bring valuable innovation and investment and can run a railway more efficiently than the state. Competing private companies are preferable to a monopoly. Private management of rail companies cuts strikes.
- **Cost of buying assets back:** It would cost too much to buy back the assets that have been sold off. The Government will lose premium payments from TOCs.
- **EU law:** Any action to reunify railways under public ownership would contravene EU Directives.

This section addresses these arguments in turn.

6.2 Innovation and investment by private operators

A number of our expert interviewees emphasised that during its later years British Rail was an innovative organisation that achieved both major efficiency gains and improvements in passenger services, most prominently with Intercity but also with commuter services including Network Southeast. Despite its inefficient reputation in passenger folklore, the last year of British Rail saw UK railways achieve 56% more train kilometres per member of staff than the European average[56].

Most of our interviewees struggled to identify examples where private sector railway companies had introduced innovation or investment which had benefited passengers. While one interviewee suggested that the improvements at Chiltern Railways were an example of private sector innovation, others argued that where improvements had been made, as for example with Chiltern Railways or East Coast Main Line, these had been initiated by British Rail and funded by public money.

> *"They're not investing. Nor are they really innovating. Not all that much. Most of Chiltern's investment has been funded on the Network Rail RAB and Chiltern built it. There are some parkway stations that they have built on their own land. But most of Evergreen 3, the new one, is being funded by Network Rail from the regulatory asset base."*
>
> Roger Ford, Industry & Technology Editor *Modern Railways*

> *"Look at East Coast Main Line. The electrification and improvements were all under BR in its dying days and the TOCs have not come up with any new ideas. They're still running HST diesels that were introduced in the 1970s out of King's Cross. I know they've got the 225s, but the idea behind them was initiated by British Rail. They were going to have tilting trains on that line but they never bothered investing in them."*
>
> John Stittle, Senior Lecturer in Accounting, University of Essex

Some innovations that could have benefited passengers have been stifled by privatisation. For example, setting up zonal urban smart card ticketing systems to include rail is considerably more difficult when the negotiation involves multiple operators. There was a feeling amongst a number of our interviewees that

privatisation had created a complex and bureaucratic structure in which innovation was more difficult.

> *"It's about getting a structure which is sufficiently flexible and dynamic to allow development of the rail network to meet passengers' needs as well as wider social, economic and environmental needs. It has to avoid just becoming a bureaucracy where nothing happens, which is what we have now to a large degree. It's more difficult doing anything new now than it used to be."*
>
> Paul Salveson, Visiting Professor, University of Huddersfield

This impression of a railway in which innovation is discouraged by a complex and fragmented structure was also noted by the McNulty report[57], which commented that:

> *"Players within GB rail are more inclined to follow approaches which maximise their position within their own "silo", rather than optimising outcomes for the industry as a whole, for example in the areas of technology and innovation."*

Evidence of private sector investment in the railways is also disappointing. The yearly survey of private investment in rail for the Office of Rail Regulation[58] shows total private investment in 2010-11 of £377 million. During the course of this research, we sought to obtain a breakdown of this figure, so as to understand the extent to which it represents genuine 'at risk' private investment, as opposed to capital expenditure by a private company which is underwritten by the Government. Despite the assistance of the ORR and the Office for National Statistics, we were unable to obtain this information because the individual companies from which the data are collected by ONS refused permission for ONS to disclose it to us, even at the sectoral level (that is, for different parts of the rail industry). Given the substantial *public* investment in the railways, and the oft-put justification for private sector involvement that it provides substantial *additional* investment, this lack of transparency is very unsatisfactory.

However, we are able to make some high-level observations about the level of private investment implied by the ORR survey. First, the great majority of the £377 million private investment in 2010-11 (£274 million, or 70%) represents purchase of rolling stock, most of which is likely to be by ROSCOs. While technically considered as private expenditure, this is underwritten by franchise contracts which are only rendered financially attractive by the public subsidy to Network Rail and in most cases a public subsidy to the TOC that will be leasing the trains. This dependency on public support is illustrated by the minimal extent of speculative purchase by ROSCOs: of the 4,700 new-build vehicles between privatisation and mid-2006, only 158 were purchased by the ROSCOs without already having a firm order[59].

Second, private investment by TOCs appears from the ORR survey to be minimal, and as with the ROSCOs it is underwritten by public money. The ORR survey of private sector investment in rail shows private investment in stations (most of which is likely to be by TOCs) at £28 million in 2010-11; and 'other investment' (e.g. non-rail vehicles; information technology) at £74 million.

No further private investment is identified by the ORR survey. Thus, genuine at-risk private investment in the railway in 2010-11 lay somewhere in the range £100 million – £380 million, with the figure most probably lying at the lower end of this range, that is, around £100 million. In the same year, *other* sources of income for the railway – public money and the farebox – contributed £10.6 billion. In other words, private

investment seems to represent about 1% of the money that is going into the railway. As we have already seen, the additional costs posed by the privatised structure of the railway are considerably more than £100 million per year.

This assessment of the low level of private investment in the railway was borne out by our discussions with interviewees.

> *"In so far as there has been private sector investment by TOCs, that investment has been funded, let's be clear, by the state and by passengers, either through revenue support or through fares."*
>
> Andrew Adonis, former Secretary of State for Transport

Some TOCs have claimed to have invested significant sums in the railway and it is relevant to debunk these here. For example in 2011 Virgin media office issued a 'fact' sheet saying: 'Investment in trains by Virgin Trains was £1.2bn for Pendolinos and £1.06bn for Voyagers'[60]. But none of these trains were purchased with money invested by Virgin and none of them are owned by Virgin (indeed the Voyager trains are now operated by Arriva). The Pendolino trains used by Virgin on West Coast Main Line are owned by the ROSCO Angel Trains and their purchase was underwritten by public money.

Similarly, Chiltern Railways press office have issued the claim that: 'Since being awarded the franchise in 1996, Chiltern Railways has invested over £400 million to improve the railway and to ensure stations meet the needs of passengers. Currently, Chiltern Railways is working on a £250 million project to reduce journey times to London by 20%, with no recourse to the taxpayer.'[61] However the funds for these projects are actually being provided by Network Rail, who at the same juncture issued their own press release[62] stating that 'Network Rail is funding a £250 million project to create a new main line from London to Oxfordshire'. Despite Chiltern Railways' claims, the £650 million bill will be loaded onto Network Rail's debt which, as discussed elsewhere in this report, Network Rail has no hope of redeeming without money from the taxpayer. Network Rail will seek to recover some of the money from Chiltern Railway (or rather its passengers) via higher facilities charges, but the level of charge offers no prospect of recovering the debt until 10 to 20 years after the end of Chiltern Railway's franchise on the line[63].

While there is little evidence of private investment from ROSCOs or TOCs, the freight companies may have a better case that they have invested. The Rail Freight Group estimates that £1.5 billion has been invested since 1996[64], and it is clear that there has been significant spend on new locomotives and wagons. At least some of this spend appears to have been made 'at risk', in order to try to win contracts rather than in sure knowledge that a contract was already in hand.

6.3 Efficiency of private operators

As we have seen, more than a quarter of the public monies paid to the railways in 2009/10 (£1.2 billion out of £4.6 billion, or 26%) was lost in the form of dividends, debt interest payments at rates above those paid by government, and interface costs between different parts of the privatised railway. This makes it very difficult for the privatised railway to be competitive, in terms of value for money, with a unified operation under public ownership, which would face none of these costs.

It may be the case that individual private rail companies have put considerable effort into management systems to control costs. However, this does not appear to have

achieved an overall increase in efficiency, and in fact the McNulty Review suggests the opposite. McNulty[65] suggested that many of the prerequisites that are necessary for the rail industry as a whole to make efficiency improvements are missing from the system as it currently stands. His lengthy list of barriers to efficiency includes (amongst many other factors):

- the difficulty of securing cooperative effort between different organisations at operational interfaces;
- commercial interests of TOCs leading to an unhelpful degree of short-termism;
- a complex framework which engenders significant additional costs in recording and negotiating the various rights, remedies and compensations that are provided for within it;
- too much 'gaming' of the system by some players, instead of seeking real value-adding improvements;
- supply chains in which demand is unpredictable and fluctuates wildly;
- players within the industry following approaches which optimise their position within their own 'silo', rather than optimising outcomes for passengers or the railway industry as a whole.

In his review of the barriers to efficiency in the UK railway, McNulty also comments that other European countries gain advantage through more integrated planning of timetables, infrastructure and rolling stock – a theme to which we return in section 10.

The McNulty review also criticises the privatised railway for not achieving efficiencies in the labour force. This is a rather remarkable criticism, since the privatisation of Britain's major publicly-owned industries was seen by politicians of the day as a way to tackle what they regarded as entrenched inefficient employment practices.

McNulty[66] notes that:

- *'Average earnings for the GB rail industry have grown faster than earnings for the economy as a whole'*
- *'Increases in staff numbers have outstripped growth in train-km, thus causing labour productivity to fall'*

However, McNulty fails to note that these increases are due to increased numbers of administrators and managers, not more front-line staff that might have brought service benefits to passengers (although the McNulty report does propose to cut front line staff to make up for these extra back-room staff). An academic analysis[67] of the UK rail industry since privatisation has found that costs of 'transaction' staff – administrators and managers – rose 56% over the twelve years in question, measured per train kilometre (an absolute cost rise of 83%). During this period, administrative and managerial jobs, measured as a percentage of the workforce, rose 22%. As the study points out, because of their relatively high white-collar wage levels, the proportionate rise in wage costs is much higher.

This effect is a direct result of the fragmentation of the industry, producing duplication of functions in the different private companies and new staff to deal with all the interfaces between those companies. The resulting cost increase is exacerbated by the marked tendency during the period in question for top managers' salaries to outpace those of the bulk of their staff, a point that McNulty[68] does note:

- *'Earnings of the industry's leaders have also moved ahead of average earnings and inflation'.*

6.4 The merits of competition versus monopoly

Certain of our expert interviewees made the point that a monopolistic provider of services can afford to be complacent about customer service, although British Rail has both critics and defenders for the level of service it achieved before being abolished.

However, many of the present private train companies also hold effective monopolies for large segments of their routes, and their service levels for some of these have been so bad as to lead to commuter protests and even commuter strikes[69]. Many of our expert interviewees made the point that the railway is a 'natural monopoly'.

The present system seems to offer the worst of both worlds: monopolistic practices deployed by private companies that are beyond effective regulatory reach, without the advantages that a unified provider can deliver. It would seem far better to realise the convenience and connectivity from a network-wide unified railway operator, with the additional advantage that such an operator could be brought sufficiently under public control that it could be properly regulated to ensure high standards.

6.5 Industrial relations in the privatised railway

There is a tabloid canard that national publicly-owned industries equate to a 'licence to strike', with more industrial strife and the public at the ransom of muscular unions. In reality industrial relations on the railways were better under British Rail, and there has been a considerable worsening of industrial relations since privatisation. In the seventeen years from 1979 to 1996 there were only eight strikes; whereas there are now a number of serious pay disputes every year[70].

6.6 The cost of buying back the railway

At the Labour Party Conference in 2004, Gordon Brown and Alistair Darling argued that the cost of bringing the railway back into the public sector would be £22 billion[71].

However, from our discussions with experts, we believe that the railway could be brought into public ownership *without* large expenditure. Through a step-by-step approach, the railway's assets could be reacquired for the public at minimal immediate cost, with substantial ongoing savings being realised over time.

The cheapest (and easiest) approach with regard to the train operating companies is to acquire these as franchises expire or as companies fail to meet franchise conditions. On past showing this is liable to happen regularly and might be more frequently precipitated if franchise conditions were strictly enforced. No costs would accrue to government if it waited until expiry of a franchise. There would be a small cost to regain a franchise from a failing franchisee, but this would probably be less than keeping the franchise afloat with a bail-out. For example, in the case of Connex South Eastern, the administrative and legal costs plus residual liabilities amounted to some £6.6 million, of which £2.8 million was recovered from Connex and the NAO considered that more could have been[72].

Whilst up-front costs could be minimised by this step-by-step approach to bringing TOCs back into public ownership, there might come a point at which the one-off cost of buying out the remaining franchisees would be justified by savings from a completely unified operation that avoided the ongoing costs of residual fragmentation.

Considering infrastructure, Network Rail does not need to be repurchased. It merely requires steps to make it properly accountable for the public monies it receives. Formally making Network Rail a public body carries the essentially *political* consequence of facing up to the £24 billion debt that would show on the government balance sheet as public debt. *Financially*, however, this would save £156 million per year because of the government's superior credit rating[73]. Regardless of how the railways are managed in future, Network Rail's debt is utterly unsustainable for the future of the railway and will have to be shouldered by government eventually. The history of railways all over the world shows it is not feasible to make sufficient operating profit to significantly reduce this level of accumulated debt. The countries with the world's best-maintained best-run railways accept that they can only make profits on some parts of their operations and recognise that social, environmental and economic benefits justify use of public money for investment in railway improvements and to support important services.

In regard to procurement of rolling stock, removing the ROSCOs from the system could bring savings to the public purse rather than costs. Direct procurement of new trains would be cheaper than leasing new trains from the ROSCOs. Existing rolling stock would still be leased, but costs could be brought down through regulation of the rolling stock leasing market to ensure a fair price.

The freight sector is a different matter. These private companies could not be bought without significant cost, and anyway, unlike the domestic passenger sector, this sector must be open to private competition because of EU legislation. We discuss later possible options for the rail freight sector that could deliver desirable social, economic and environmental benefits.

6.7 Premium payments from train operating companies

Some train operators make premium payments to Government under the terms of their franchises. These are only possible because the Government makes much larger payments to Network Rail, enabling low track access charges and thus giving the TOCs the appearance of being profitable entities.

> *"Four or five years ago they changed the centre of Government grants, so instead of many subsidies going to the TOCs they gave a massive great slice to Network Rail. In return NR cut the track access charges. So now Virgin is paying far less in track charges for West Coast Main Line. Hence it is now paying a premium. And it's all because of the allocation of where Government funds go. If you're trying to show that the private sector TOCs are viable entities then you don't want them receiving subsidies – it's much better if they are paying premiums. So rather than give them government funds, give the funds to Network Rail. That is what is happening. As a result TOCs such as Virgin can more easily extract considerable funds from the rail industry in the form of dividends - which otherwise could have been reinvested in the industry."*
>
> John Stittle, Senior Lecturer in Accounting, University of Essex

A misunderstanding has arisen that if the Government were to reclaim a franchise before it ended, it would incur a financial cost in the form of loss of premium payments from the train operator. This is not in fact the case. No money would be lost to Government under these circumstances, because direct Government operation of the franchise would capture any profits that would have funded TOC

premium payments. To the contrary, should the Government take over a money-making franchise there would be an increase in income, since profit leakage to TOC shareholders would be eliminated.

For those franchises involving premium payments, the profile of these payments is that they will increase over time, sometimes quite steeply. In some cases this may mean that the franchise will become valueless, or even a liability, for the operator. Under these circumstances there will be a continued legal obligation for a train company to make premium payments, even if it would record a loss by doing so. However, where operating revenues do not support premium payments, past experience suggests that such payments are unlikely to be made. This is because there is little penalty associated with abandoning a franchise. The bonds on TOC parent companies amount to trivial sums in comparison to the prospective losses from premium payments, and as free-standing 'special purpose vehicle' companies set up specifically to run a franchise, the TOC can be shut down without wider financial consequences for its owners[74]. Thus, expectations that large premium payments will be made to the Government over the next five to ten years are in any event probably erroneous.

As discussed in later sections, reclaiming a franchise just at the time when the size of the premium payment effectively renders it valueless may be an attractive option for reuniting passenger operations under public ownership at very little cost to the public purse.

Although the structure of future franchises is still under discussion, the profile of premium payments seems unlikely to alter dramatically. A detailed accountancy study of the failed East Coast Main Line franchises concluded that the tendency for train operators to put in bids with this premium profile is a fundamental structural feature of the franchising system:

> *"Under pressure to produce attractive premium profiles in their bids, operators will often, quite naturally, backload the premium payments in their tenders, ensuring profits in the early years of the franchise, which can be extracted as dividends or management charges, leaving very little in the way of assets, but if there are losses the franchise can be abandoned, the SPV put into liquidation, and the state bears the financial consequences."*[75]

6.8 EU Directives and public ownership

Despite arguments made at the time of UK rail privatisation, European legislation does not dictate that railways must be fully privatised. There is no requirement under EU legislation for railway infrastructure to be in private ownership. Nor is there any bar on train services being operated by a Government-owned enterprise. The UK went far beyond the requirements of EU law when it privatised its railways, whereas other EU countries generally chose a minimal interpretation. Moreover, these countries have been prepared to argue the case for their interpretation right through to the European Court of Justice so as to obtain the most favourable possible judgement and in the meantime gain years of delay during which time they retain their coherent railways.

Figure 8 summarises the current legal situation. It sets out how this may change under the latest 'Recast' of EU railway legislation[76], presently going through the European Parliament. It also shows how the rules may change further if the 2011 EU

Transport White Paper[77] leads to further legislation in the form of a 4th Rail Package, proposals for which are likely to emerge in the course of 2012[78].

Figure 8: EU rules on ownership and management of national railways

	EU rules now in force	EU rules if draft 'Recast' Directive is adopted by EU Parliament	EU rules if legislation results from EU Transport White Paper	What the UK has decided
Railways must be privately owned?	NO	NO	NO	YES
Running of train services and railway infrastructure must be completely divorced?	NO	NO	NO	YES
Trains must be leased from private companies?	NO	NO	NO	YES
Domestic passenger services must be open to competition?	NO	NO	YES	YES
Railways should be regulated by a body that is not the Ministry of Transport?	NO	YES	YES	YES
Domestic freight services must be open to competition?	YES	YES	YES	YES
Railways must hold assets, budgets and accounts separate to those of the State?	YES	YES	YES	YES
The manager of railway infrastructure must draw up separate accounts to the provider(s) of train services?	YES	YES	YES	YES
Certain 'essential functions' of infrastructure management must be independent of train operators?	YES	YES	YES	YES

The EU Commission has so far failed to secure member states' agreement that internal (domestic) passenger operations should be open to private competition, although it is likely to continue to pursue this. The latest 'recast' of EU rules, presently going through the European Parliament, only re-states the existing laws that national rail networks must be open to private competition for rail freight operations and cross-border passenger operations.

EU legislation does contain a stipulation that the accounts for infrastructure management must be independent of accounts for train operations. It also specifies that certain 'essential functions' of infrastructure management must be independent of providers of train services. These 'essential functions' are those of providing 'non-discriminatory access to infrastructure': access charges and train path allocation. To this end the EU 'Recast' of the Rail Directive[79] states that these functions must be 'entrusted to bodies or firms that do not themselves provide any rail transport services'. It also, however, explicitly states that it is acceptable for other

infrastructure management functions, such as maintenance, to be assigned to operators of train services.

Various countries are in dispute with the EU about exactly how they have chosen to address the 'essential functions' stipulation. In assessing alternative structures for the UK railway, it is interesting to note that the EU Commission's arguments against Germany in the Court of Justice appear to accept that the structure of an overarching corporate railway group that encompasses legally distinct companies for rail infrastructure and train services could be acceptable with 'appropriate and adequate precautionary measures'[80]. The sort of precautionary measures cited include supervision of the independence by an independent authority; prevention of shared directors and 'revolving door' appointments between the parent company and the subsidiary company responsible for the 'essential functions'; legal duties on the subsidiary company managers to act independently; and separation of staff, premises and information systems.

> *"EVG [German rail union], Deutsche Bahn and the government think that the German system of an integrated company like DB is compatible with European law. The [latest] proposal of the EU is saying that a legal separation of infrastructure and rail operators is not necessary."*
>
> Dirk Schlömer, Divisional Director, Passenger Transport, EVG

In overview, it is striking that EU countries have, in various different ways, accommodated EU rules whilst largely or entirely retaining public ownership of their railways and avoiding the fragmentation that the UK has suffered.

Although the discussion here is in no respect a comprehensive review of all the points of law that could be exerted in favour of a unified railway in the UK, it does show that there are a number of aspects of the laws in question that are open to legal interpretation and argument. Other countries are testing these at the level of individual cases in the European Court of Justice. A future UK Government that wished to obtain a reunified railway should abandon the slavish approach to EU railway law that has characterised its predecessors and deploy its considerable institutional legal ability to defend the UK railway with the imagination and pugilism of other EU countries.

It might also be noted that even the most blatant flouting of EU law with an eventual court decision that the UK was guilty of infraction of the rail directive carries a maximum fine of £256 million per year[81], which, whilst a large sum, is a small fraction of the money the UK is presently squandering on its privatised railway. In practice the Court of Justice has shown itself extremely reluctant to levy fines, and subtly-presented legalities in defence of arguably compliant structures would make it very hard for the Court to justify maximum fines, and the delays before it could do so would probably run into years.

Part II: The solution

7. What our railways *should* be for

In considering how our railways should be reformed, it is important to focus not just on the mechanics of reform, but on what we want that reform to achieve – that is, a vision of what our railways are for.

A well-structured fit-for-purpose national railway system would provide the means to achieve a variety of important objectives. Although it seems almost inconceivable given the current state of the railway, we should seek to create a public service that people – both passengers and the workforce – are proud of, rather in the way that people feel proud of the NHS.

In order for passengers and workforce to feel that sense of pride, the railway would need to have a very clear idea – at every level of the organisation – of what its role was, and this would be very differently defined from the role of the railway at present. It should include:

- Providing a high quality service that passengers understand, with simple system-wide ticketing and affordable fares;
- Tackling overcrowding by expanding capacity (rather than pricing people off trains);
- Seeking ways to stimulate local economic regeneration through investment in better rail services;
- Rebuilding a rail manufacturing base in the UK, as a basis for then exporting our skills and technology to other countries;
- Helping create uncongested liveable cities like the best in Europe through the expansion of urban rail networks;
- Reducing carbon emissions by moving more freight from road to rail (especially by encouraging palletised freight movements), as well as by providing passenger services that are an attractive alternative to driving;
- Reducing longer rail journey times so that flying becomes comparatively less attractive, in the way that Spain has achieved mode shift from air to rail;
- Working with developers, development agencies and planners to integrate rail services with land use planning, so that users of major new developments can travel sustainably rather than being car-dependent;
- At the regional and local level, making the railway function as part of a seamless public transport system;
- Perhaps above all, creating a strong ethos of public service, in which all staff feel they are working to create the best possible railway, for the benefit of all of us.

The railway is potentially a powerful tool to achieve these economic, social and environmental benefits.

However, attaining these benefits needs overt recognition – largely lost from the UK political debate in recent decades – that the purpose of the railway system is primarily to provide a public service, not private profit.

> *"Public ownership is important because it brings with it a political commitment to the role of rail in advancing broader public policies - policies to do with environment, social mobility, social inclusion, poverty, housing and other matters. All of these issues can not be left to the private sector and the profit motive alone. In that way we either won't achieve them at all or they will be achieved only patchily as an accidental byproduct. Public ownership and regulation means you can meet communities' needs, businesses' needs and the economy's needs."*
>
> Diana Holland, Assistant General Secretary, Unite

8. Rail reform and an integrated transport system

It was clear from our interviewees that their aspirations for reform of the railways were not only about creating a much better national network of train services, but also about improving the integration of the public transport network of trains, metros, trams and buses within individual regions, and creating more locally accountable structures for running local public transport.

> *"A more integrated transport strategy comes down to regional transport authorities. Switzerland is a wonderful example, with tram schedules that fit with bus schedules that fit with train schedules and a whole thought-out policy of where each of those modes is most appropriate. But we are so far back from that now. We have to challenge the Competition Act to allow authorities like Newcastle to integrate bus services, so they don't compete with rail but work together – as they do everywhere in Europe."*
>
> Christian Wolmar

> *"Looking at a local branch line and a local bus service entirely separately, with separate funding streams, separate administration, just doesn't make any sense. Take Whitby, where the Whitby branch is totally separate from local bus services in terms of the way it's paid for. In some countries that might be one company, or a trust, where the train driver might be driving a bus or in the control centre some of the time, as part of the wider economies and also making it a more interesting job, to be frank."*
>
> Expert Interviewee

> *"It is really important that we get devolution to regions and counties. Having a regionalised structure in England would allow you to look at some routes, like some of the more rural lines, and run them as quasi-independent operations covering buses as well as trains. Deutsche Bahn do this. There's a very interesting operation to and within the Isle of Usedom, which is more or less self-contained. The local rail service, the Usedomer Badebahn, is a very high quality modern railway, with excellent inter-connection with buses. Everything is marketed as the Usedomer Badebahn, as the local railway."*
>
> Paul Salveson, Visiting Professor, University of Huddersfield

The potential for improvement is vast. In metropolitan areas thorough integration of all forms of public transport would enable passengers to use one ticket for the whole of their journey, for example including the bus from their front door in the suburbs to the local station, the local train into the city centre, and then a metro service to their final destination. In rural areas, or outer suburban areas, where service frequencies are lower, it would enable bus services to be planned to connect with trains, so that a passenger alighting from a train at a station in the evening or at weekends could be sure that there would be a bus waiting for them.

A larger role for regional bodies, such as ITAs, in determining the shape of the transport network in their area, would potentially unlock sources of funding for the railways which are currently unavailable, such as developer funding. It would also result in a closer focus on local economic and social priorities: for example, a transport authority in the north of England would be likely to give high priority to replacement of old Pacer trains on services between Sheffield and Manchester.

"If you get more local, close attention, you can do a lot more with what you've got. If PTEs had greater control over revenue streams they could use that money to lever in other investments. For example, a conversation with pension funds about how they might invest in the railway. The West Yorkshire Pension Fund could say 'we want to invest in West Yorkshire'. At the moment they won't because they can't see where the money is going. They've got no confidence that it would stay in the area. But if you create a more local relationship, if the PTEs were driving things, we could have conversations with investors."

Matt Brunt, Assistant Director, Passenger Transport Executive Group

In order for rail and other public transport services to be integrated at the regional or local level, the powers of Integrated Transport Authorities (and equivalent bodies in areas that lack an ITA) would need to be extended, so that they could exercise influence over the full range of public transport services, including regional and local rail services. This is standard practice in many parts of Europe, but is immensely difficult under the present UK system. Most UK transport authorities that oversee bus services (with inadequate powers even to do that) have very limited influence over the provision of train services that may, moreover, involve dealing with a multiplicity of train operators. They also have very little influence over Network Rail's investment priorities for rail infrastructure. EU regulations explicitly recognise that it might be desirable for local authorities to run their own transport services in the interests of achieving an integrated transport system[82]:

'Any competent local authority... or a group of authorities providing integrated public passenger transport services, may decide to provide public passenger transport services itself or to award public service contracts directly to a legally distinct entity over which [it] exercises control similar to that exercised over its own departments.'

Any reform of the railway should reflect the desire for a bigger regional role in shaping public transport services. At the same time, it is important that we do not replace one form of fragmentation of the rail network (into many private companies) with another form of fragmentation (into many regional fiefdoms). We set out in Section 11.5 how we believe the right balance can be struck.

9. Rail reform to rebuild Britain's rail manufacturing base

Reform of the railway also offers an opportunity to rebuild Britain's rail manufacturing industry. The potential gains are clearly evident from the other countries in Europe, such as Spain, France and Germany, which have succeeded in procuring trains in such a way that their domestic train manufacturers have received a large portion of their orders and have grown in strength.

A key difference to the UK is that, in seeking and comparing bids, other countries take account of the economic and social consequences of procurement decisions, for example benefits arising from receipts of tax revenues from domestic jobs, as compared with the costs of social support to redundant workers.

The benefits of this reach far beyond the direct jobs involved. Bombardier has calculated that for each pound spent in their factory, two pounds goes into the UK economy[83]. Other research has found that every 100 jobs in the rail industry support a further 140 'indirect and induced' jobs in other industries[84]. There is also a benefit to be won in the form of higher tax revenues for the public purse. The tax lost to the Treasury by awarding the Thameslink contract abroad has been estimated at £20 million per year, on the basis that 1,000 jobs could have been secured at Bombardier's Derby plant if they had been awarded this contract[85].

What other European countries have achieved is striking in contrast with Britain. For example, there are 72,000 jobs in the German rail engineering supply chain, compared to just 8,000 in the UK. This is partly a direct result of the larger size of the rail manufacturing industry in Germany, but it also reflects the way in which rail procurement in Germany has supported the domestic supply chain with a steady flow of orders. German rail engineering companies are able to source 55% of intermediate components from their domestic supply chain, whereas in the UK the figure is just 25%[86].

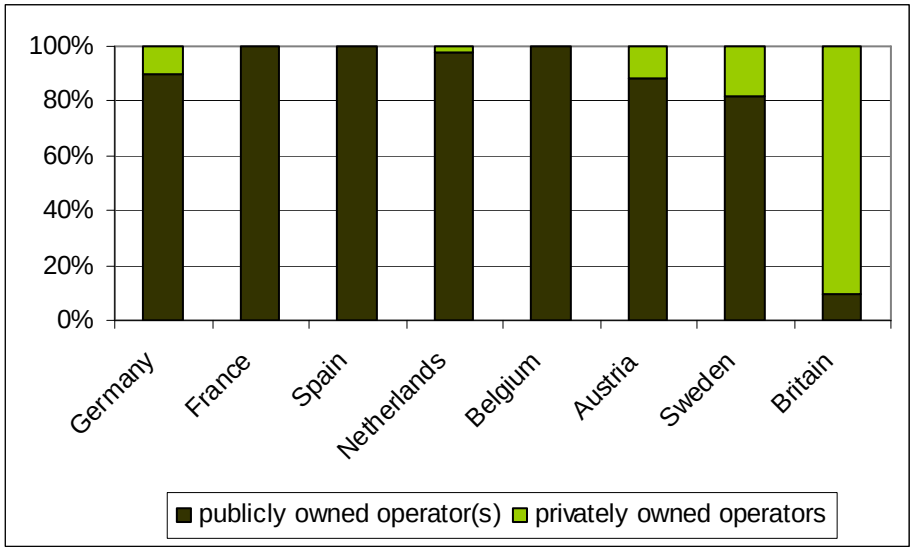
We set out in Section 11.14 the practical steps that the UK could take to recreate a thriving domestic train manufacturing industry as part of a programme of railway reform.

10. How the railway is structured in other countries

In considering options for reform of the railways in Britain, we reviewed professional literature on railways in other countries for lessons applicable to the UK. The review included examples from both inside and outside the EU legislative framework and examples representing various positions along the state-run / privately-run spectrum. Our research also included an in-depth questionnaire and written exchange with a German railway expert to probe pros and cons of the German rail system, and interviews with experts who could offer particular insights into the Spanish railway. Both of these countries' railways offer some particularly relevant features for the UK and are covered in somewhat greater depth.

The situation in other European countries is strikingly different to Britain, with tracks and other infrastructure in public ownership and a publicly-owned train operator that provides the majority of passenger train services, as summarised in Figure 9.

Figure 9: Passenger market share of private and public operators in Europe[87] [88]



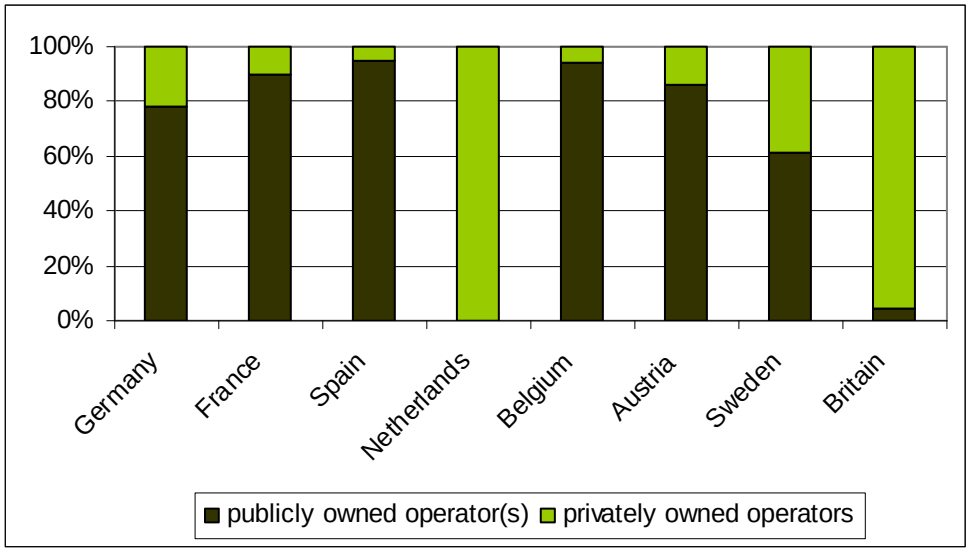
Comparable figures not available for Switzerland or Italy, but in both countries passenger operations are almost entirely by state-owned rail company.

British railways cost more than they should by comparison with European railways. The McNulty report on the costs of UK railways[89] compared the costs of the British railway against those of France, Netherlands, Sweden and Switzerland. It concluded that 'GB rail costs would need to be reduced by around 40% to match those comparators', what it termed a '40% efficiency gap'.

As we have already seen in Section 3.1, rail fares are also lower in other European countries.

Publicly owned companies also carry the majority of rail freight in most other European countries, although as a result of EU rules that domestic rail freight markets must be open to private competition their market shares are lower than in their domestic passenger markets. The overall picture of rail freight ownership in Europe is summarised in Figure 10.

Figure 10: Freight market share of private and public operators in Europe[90] [91]



Below, we summarise the structure of the railway systems of each of the countries that were covered in our review. Some geographical-social-historical features of individual countries are also described where these are pertinent to the structures of their railways. This section concludes by drawing out possible lessons for the UK's railways.

10.1 France

France operates a very extensive conventional rail network and over recent decades has also succeeded in building a large high speed train network. These offer excellent train connectivity across the country with generally lower fares than in the UK.

Both the train operator SNCF and the infrastructure operator RFF are state-owned. RFF owns the track and performs a strategic management role, but contracts many network management functions back to SNCF. SNCF still runs nearly all train services. [92]

The skin-deep reforms that France has instituted to its railways in response to EU rail directives are close to the minimum possible. Indeed, France is facing European Commission challenge of its rail structures, including infringement procedures on the grounds that the incumbent train operator is responsible for the 'essential function' of allocation of train paths (and is therefore too closely involved in controlling access to infrastructure) and that the rail regulator is too weak.[93, 94,]

SNCF is structured into five divisions. Three of these cover infrastructure, stations and freight services. Passenger services are divided into two divisions.[95]

- SNCF Voyages operates long distance and high speed services, including TGV.
- SNCF Proximités operates urban and regional services, including TER (regions outside Paris area), Transilien (greater Paris area) and Intercités (linking regional cities).

Each regional council has a contract with TER to deliver a specified level of train services, and these are funded accordingly by the state government. The regionally contracted services require subsidy but SNCF Voyages is expected to return a profit.

Freight is operated by SNCF on commercial principles, with a limited amount of competition from small operators. The only major private sector involvement in operation of the French railways is in maintenance, undertaken by major civil engineering firms. It is notable, however, that France's approach to procuring rolling stock for SNCF has sustained train manufacture in France, most notably Alstom, which manufactures both high speed and tilting trains.

10.2 Germany

Germany also has a large rail network, including high speed train routes. Like France it retains a state-owned operator that runs the great majority of services, but in Germany a greater proportion of passenger services (10%) are operated by other companies. A notable structural difference to France is that Germany has chosen to operate both its infrastructure and most of its trains as corporate subsidiaries to a single overarching corporate body, Deutsche Bahn Group.

German railways were reformed in 1994, at which time principles of operation were written into the German Constitution. Amongst other matters this stipulates that, although the state continues to own the Deutsche Bahn Group of railway companies, its infrastructure management companies must be run on commercial principles[96]. The operational arrangements also reflect Germany's structure as a federation of states (Länder).

> *"The main strengths [of the German way of running its railways] are:*
>
> *- The integrated system, which includes infrastructure and rail operators;*
>
> *- Reliable annual investment into the rail infrastructure and into the public transport services.*
>
> *We have two different financial sources, both national sources.*
>
> *Firstly, we have a law to finance public rail services. It guarantees nearly €7 billion annually for public transport services. The money is for service contracts and rolling stock. The money is given to the 16 states in Germany and the states have to organise public services of their own. Service contracts normally contain the timetable, specification of rolling stock, ticket pricing and further quality standards.*
>
> *Secondly, to maintain and develop the rail infrastructure there is a law to spend €2.5 billion annually."*
>
> Dirk Schlömer, Divisional Director, Passenger Transport, EVG

Deutsche Bahn runs longer distance services across Germany at a profit (in the context of the state financing the rail infrastructure). Local services, however, are subsidised by the Länder, who in turn receive federal monies to specify and offer competitive tenders for these routes. Deutsche Bahn's success in retaining a 90% share of all passenger services is at least in part a consequence of its ownership of nearly all the rolling stock. However, in theory all passenger routes are subject to open-access competition and a number of regional and local services tendered by the Länder are now operated by rival companies. Some Länder also own and operate their own local rail networks[97].

"The evidence from Germany where you have regional devolution is of massive improvements in rail services. That has been led very much by the regions, sometimes with sub-regional bodies."

Paul Salveson, Visiting Professor, University of Huddersfield

The German Federal Government operates a 3-year 'Rail Financing Cycle' to meet infrastructure enhancements specified in the Federal Transport Infrastructure Plan. Over the last 16 years Federal spending on infrastructure maintenance, upgrade and new-build has run at some €4.5 billion per year[98]. The German approach to train procurement has sustained a strong domestic train manufacturing industry, most notably Siemens.

The German railway structure is being subjected to criticism by the European Commission, including infringement procedures that claim control of railway infrastructure is not sufficiently independent of the incumbent train operator[99]. The German Government and Deutsche Bahn strongly contest these claims[100].

As well as operating in Germany, Deutsche Bahn has a number of subsidiaries which operate in the UK: three passenger franchises (Arriva Trains Wales, Arriva Cross-Country and Chiltern railways) are owned by Deutsche Bahn, as well as the dominant UK freight operator DB Schenker. Ironically, this means that the German Government is able to extract profits from the privatised UK railway, to invest in its own railways. Because the German government is sole shareholder in Deutsche Bahn, no money leaks out as private dividends. In 2011, it claimed its first dividend of €500 million from Deutsche Bahn, and this is due to rise to €700 million by 2015. A German transport ministry spokesperson described the rationale for the payment thus: *"We're skimming profit from the entire Deutsche Bahn and ensuring that it is anchored in our budget - that way we can make sure it is invested in the rail network here in Germany."*[101] Effectively, the German Government is achieving higher investment in German railways by capturing monies that could have been invested in the UK railway, if the UK Government had not let them leak out as corporate profits.

10.3 Italy

Italy's railways are run by an overarching state-owned railway company called FS Holding, which owns both the national rail infrastructure manager RFI and train operating company Trenitalia. This corporate structure is somewhat similar to that in Germany, but unlike in Germany, private operators are largely absent.

Trenitalia is by far the dominant provider of train services, which fall into three principal categories[102]:

- Long-distance services (Intercity and Eurostar brands) that are in principal commercially viable, with Trenitalia deciding its own service levels. However, some of these services receive indirect grants from government and the regions.
- Public Service Obligation overnight long-distance services (Espresso and Intercity Notte brands) that are funded by the Government. At present Trenitalia operates all these services, although there is provision for public tender.
- Regional services that are procured by regional governments through negotiation or, in some cases, by public tender.

Italy also has a number of regional operators, often owned by the regions and serving major regional cities such as Milan or Naples. These services generally do

not use the national rail network. There are also some international services between Italy and Switzerland which are operated by a joint venture (Cisalpino) between Trenitalia and Switzerland's SBB.

Italy is in dispute over its rail structures with the European Commission, who have brought infringement procedures on the grounds that the incumbent train operator is too closely involved in controlling access to infrastructure and that the rail regulator has insufficient power and independence[103].

10.4 Netherlands

The Netherlands has a much smaller rail system than France, Germany or Italy, but the Dutch Government nevertheless contrived a response to EU rail liberalisation that created more complexities and problems, albeit far fewer than in the UK. This has now been reversed to a degree, and the Netherlands still stands as an exemplar of how to integrate rail with other forms of public transport at the local level.

The Dutch Government decided to reform its railways during the 1990s, creating a state-owned company ProRail to take over the infrastructure management functions of Nederlandse Spoorwegen, which continued in public ownership as a provider of train services. The aim of this split was to promote competition in rail services, and the institutional divide that was created between ProRail and Nederlandse Spoorwegen appears to have been much wider and deeper than that in most other European countries (Britain excepted).

The transfer of rail traffic control to ProRail seems to have been particularly problematic, with the development of a confrontational 'blame' culture between ProRail and Nederlandse Spoorwegen. Much controversy ensued because this and other problems associated with fragmentation caused a deterioration in punctuality to unsatisfactory levels, a rise in costs, and a 70% increase in signals passed at danger, all accompanied by significant fare increases[104].

As a result the Government rowed back from its privatisation plans and defined a core network of main lines to try to reduce the complexities of fragmentation[105]. Nederlandse Spoorwegen was awarded a ten year contract to run this part of the network.

Beyond the core network, it is the several tiers of Dutch regional authorities (cities, provinces and 'framework act areas') that take responsibility for rail as part of their devolved responsibility for all public transport. The transport ministry specifies minimum regional service levels but the regional authorities negotiate track access for the timetable that they want with ProRail, and then put non-core services out to tender, generally as an integral multimodal package including bus services and contracted taxi services. These services require subsidy and this is paid by the Dutch transport ministry (which also pays for core network services that are not profitable).

Nederlandse Spoorwegen is in theory allowed to bid for regional franchises in its own right, but in practice it has teamed up with other companies[106]. Nederlandse Spoorwegen retains 98% of all passenger services in the Netherlands[107].

10.5 Spain

Spain offers an example of a railway that has seen a period of dramatic rejuvenation in recent decades. Initial scepticism at the cost of building high speed rail lines has

been replaced by pressure from regions to be linked to the high speed network for the evident benefits it brings, including economic benefits. Although some rail reforms have been implemented in order to meet EU rail directives, the Spanish railway is largely unfragmented and almost entirely in public ownership. The way in which Spain has procured trains for its public operator Renfe has led to growth of domestic train manufacturing. Even the high speed network is accessible at what, by British standards, are low prices, and experts attribute this to a system where the state does not expect fare revenue to recover the cost of new rolling stock or infrastructure.

> *"A big difference between Spain and the UK is that when the Spanish Government makes an investment decision for the railway, it does not expect passengers to pay for it. The whole programme of investment to create the high speed rail network in Spain has been funded without expecting passengers to have to contribute. Part of the rail fare will be used for maintenance of the system going forwards, but the capital outlay to build it has been covered."*
>
> Manuel Cortes, General Secretary TSSA

The Spanish Government reformed its railways to meet EU rail directives in 2003. A government-owned company Adif was set up to take charge of rail infrastructure, whilst rail services remained the responsibility of the government-owned company Renfe. Both companies are responsible to the Ministry of Works, although as distinct legal entities[108]. This arrangement is the subject of criticism from the EU Commission, and Spain is currently resisting infringement procedures, partly raised on grounds of insufficient independence of the rail operator from the state[109].

Renfe operates all domestic passenger services on the national rail network (Catalonia, Valencia and Basque regions have separate publicly-owned railways in addition to the national network in those regions)[110]. Freight services and international passenger services are open to competition. Renfe is expected to operate its long-distance services, including the high speed routes, without operating subsidy[111]. Its Cercanias urban rail services do receive direct subsidy, as part of regional governments' provision of integrated city public transport networks that include metros, trams, and buses also run by the public sector. The regional authorities have strong influence over service levels, subsidies and fares on these urban rail networks where they form part of zonal systems covering all public transport modes, although certain rail-only fares are regulated by national Government under a system that applies to all standard Renfe fares[112].

The Spanish Government is now implementing its second Transport and Infrastructure Strategic Plan covering the period 2005-2020, partly drawing on EU funding. Rail is described as the 'star' of this plan, receiving 48% of the funding.[113] The plan defines an ambitious high-speed network. Adif's own Strategic Plan for the 5-year period 2006-2010 shows an investment of €23.4 billion, making Adif 'the biggest investing body in the country'[114]. The Cercanias urban rail services are also beneficiaries of this investment programme.

10.6 Sweden

Sweden is of interest as the first country in Europe to take steps towards privatising its railways, although it stands as a moderate in this regard relative to the UK, and state-owned rail operator SJ still operates 82% of all passenger services.

Sweden reformed its railways in 1988, with infrastructure management becoming the responsibility of state-owned Banverket and train services remaining with state-owned SJ which has subsequently been subjected to competition at the local level. Government subsidy is provided to the state-owned rail infrastructure company Banverket under a contract to run the network. The subsidy covers the costs that are not recovered through access charges, which are set at 'marginal social cost'[115].

SJ retains an effective monopoly on all long-distance train services that cross boundaries between Sweden's counties. These services are expected to operate without fare regulation or subsidy beyond that provided to the infrastructure company Banverket. In principle, if SJ were to choose to withdraw from an unprofitable route there is a provision for the Swedish Government to put it out to competitive tender, but this has not happened.

The Swedish counties control local services. These regional (and some inter-regional) services receive direct operational subsidy. The counties determine fares and service levels on these services and decide whether to buy them from SJ or other companies. When Swedish railways were reformed, the counties took ownership of all SJ's local rolling stock and this is used by whichever company wins a contract[116].

It is notable that the total cost of the railway to the State has increased more than threefold since rail reforms were introduced, although these costs include substantial 'investment costs'[117]. Nevertheless, the rail unions in Sweden have complained that there have been reduced resources for maintenance of rail infrastructure, reduced investment in rolling stock, and poor maintenance of rolling stock leading to deterioration in punctuality to levels that undermine public confidence in the railway[118].

10.7 Switzerland

Although Switzerland is not part of the EU, it has committed itself to applying the key EU rail directives and has implemented structural reforms for that purpose[119]. Swiss railways are therefore relevant to consideration of how a railway can work successfully despite EU regulations. In addition to their famous punctuality and efficiency, Swiss railways have been markedly successful at capturing high proportions of both passenger movements (16% of the modal split, as compared with 6% in the UK) and rail freight movements (39% of the modal split, as compared with just 8-9% for the UK).

Swiss railways were first reformed to accord with EU rules in 1999. SBB (Schweizerische Bundesbahnen) remained an integrated state-owned railway company, but was restructured so that its management of rail infrastructure and train services were organisationally discrete within the company, with separate accounting procedures.

SBB operates 3100km of Switzerland's 3600km rail network, with two other infrastructure managers running the remainder (BLS Netz AB and Schweizerische Sudostbahn). This situation reflects the history of Swiss railways, which partly developed as local publicly owned rail companies controlled by the municipalities or cantons[120], in some cases with their own track as well as trains (BLS is private, but with Bern local government holding a large proportion of shares)[121]. Local rail services are now arranged by the Cantons through a concession system, with specified service levels. These concessionaires may be SBB or other Swiss

companies, in which case they pay SBB track access charges if they are running on SBB network.

All national long distance services are run by SBB under a franchise. Regional rail passenger transport services are on the basis of contracts directly arranged without competitive tender. Foreign railway undertakings' access to the passenger market is restricted (to international transit movements, in essence). The rail freight market is open access and external operators have 32% of the market.

Rail freight is a particular priority for Switzerland because so many goods cross it on their way from one European country to another. The Swiss Government has a transport policy target to shift freight from road to rail, underpinned by a heavy goods vehicle tax on trucks over 3.5 tonnes. Most of the revenues from that tax are spent on railway infrastructure, including two new tunnels through the Alps at a cost of €15 billion.

The Ministry is planning for rail as far ahead as 2030, when it anticipates passenger growth of 60% and freight growth of 70%. In 2011 the Swiss Government launched a proposal for a fund to finance rail operations, maintenance and upgrade, which the Swiss Parliament will decide upon. Confederations, Cantons, transport undertakings and passengers are also expected to contribute. The ministry anticipates putting upgrade project proposals to Parliament every four to eight years on a scale of 5 billion Swiss Francs. The Swiss electorate will vote on all major infrastructure projects[122].

10.8 Japan

Japan illustrates a completely different railway structure to the approach adopted by the EU[123]. Unlike most companies created in the EU's steps towards rail privatisation, Japan's rail companies are vertically integrated, owning and operating their track.

Japan's geography, with large mountainous areas and much of the population concentrated on the south coast of the main island, Honshu, creates very high density passenger flows along the main coastal corridor. As a result, Japan's railways carry more people than any European system.

There has been a tradition of rail service provision by different companies in Japan, some within the public sector, though most under private ownership. The state-owned monopoly JNR was privatised in 1987. Six privately-owned regional companies (known as JRs) were created. The JRs operate all types of train within their allocated region, which allows cross-subsidisation between profitable InterCity services and loss-making rural lines.

All the JRs are required to separate their accounts for track and trains to facilitate them charging each other for access to each others' tracks. The Shinkansen high speed rail network has been split up between the JR regions, with each service allocated to one JR to operate, who then pays access charges to all the other JRs along the route. The JRs also run other types of trains into each other's regions, as do various other private operators. In total there are some 146 rail operators in Japan, so this system has created a complex web of interrelationships between the railway companies, which, remarkably, is largely unregulated.

Japan's private railways receive no operating subsidy, and the profitable status of its urban rail systems is in marked contrast to other countries. However, this relies upon the very high density passenger markets created by Japanese cities and Japan's

infamous levels of overcrowding on its passenger transport. This situation also reflects the way that Japan's most long-standing large private railway companies (as opposed to JRs) have over a long period acted as property developers to construct residential and commercial districts that provide them with substantial markets for their rail services[124].

It should be noted, however, that the construction of the Shinkansen bullet train network has required very major financial backing from the Japanese government.

10.9 New Zealand

New Zealand's railways are an example of an attempt at privatisation that had to be reversed.

New Zealand's railways carry substantial volumes of freight, which accounts for 75% of total rail revenue[125]. There are significant passenger flows into the cities of Auckland and Wellington, but almost no long distance passenger flows.

The railways were sold off in 1993, a few years after the Government had taken on NZ$1 billion of railway debt. But by 2003 the Government had to act to bail out the losses of the privatised rail company, at which point it took the railway infrastructure back into public hands and offered another company a contract to run just the train services. However, there was continuing disagreement over the level of services for the continued subsidies, and in 2008 the Government decided to buy the train services back for NZ$665 million. A notable feature of this failed privatisation is that the original buyers, who included Wisconsin Central, made large profits on their initial investment before exiting the company and leaving the state to take responsibility for the accumulated debts[126].

New Zealand's railways are now very largely reintegrated under state-owned KiwiRail, which operates both track and trains under separate business units. There is a railway 'Turnaround Plan' which concentrates on investments to improve freight capacity and efficiency with the intention to make rail freight a profitable enterprise[127]. It is accepted that urban services should be 'non-commercial' (i.e. subsidised) and the Government has also committed over NZ$2 billion for major modernisation and upgrade work on Auckland and Wellington's urban rail systems[128]. Services on these systems are contracted by the cities' transport agencies. One is presently operated by the publicly owned operator, KiwiRail; the other by the private French company Veolia.

10.10 Lessons for the UK

This review of how other countries have approached the provision of rail services suggests some important lessons for reform in the UK:

1. No other country in Europe took rail privatisation as far as Britain or created such a fragmented structure.
2. The countries in Europe that have been more enthusiastic about privatising rail have encountered similar problems to the UK, although to a lesser degree. Elsewhere in the world, New Zealand's failed privatisation, whilst far simpler than Britain's, records a similar story of private companies making large profits whilst the railway consumed large amounts of taxpayers' money.
3. Fares in Britain are markedly higher than for other European countries, even against trips made on high speed trains in other countries, despite a complexity of

British rail ticketing arrangements that makes its rail services much more difficult to use than those in Europe. These fares partly reflect structural costs in the UK rail system that are 40% higher than European comparators.

4. Rail infrastructure requires state financing. With the support of this indirect subsidy the general pattern is that long-distance rail services may be able to return a profit, but local services including commuter routes generally require direct operating subsidy. (Japan is the notable exception but only due to exceptional living densities and levels of overcrowding). For European countries where details are available, state financing for rail is programmed over periods of multiple years (typically 3-8 years), in some cases in the context of a much longer-term overall plan which looks 15-20 years ahead.
5. Other European countries generally operate their railways with a dominant publicly-owned train operator which has a semi-detached relationship to a publicly-owned rail infrastructure manager. This relationship may take the form of two separate state-owned companies (Spain, France, Sweden, Netherlands); separate companies within a state-owned group of companies (Germany, Italy); or divisions of a single state-owned company (Switzerland).
6. These countries have succeeded in operating this sort of structure within the context of EU railway laws. The EU Commission is challenging the way some countries have transposed EU rail directives into domestic law, but there is no prospect of any of these countries abandoning their basic railway structures in response, although it seems reasonable to predict that some may make adjustments to enable them to continue to claim compliance.
7. Regional governments in all other European countries (and Switzerland) have a major role in the provision of local rail services. This is the case even if the local trains are operated by the national state-owned train company and the financing of local services ultimately derives from national budgets.
8. A number of other European countries have been more successful than Britain at sustaining domestic train manufacturing. It is striking that these countries have also succeeded in investing in rail so as to substantially increase the size of their rail networks (whereas increased expenditure on rail infrastructure in the UK has to a large extent been directed at redressing post-privatisation neglect and consequent safety failings).

11. How a reunified railway could work in Britain

11.1 Key points

There are choices about how a future government might rebuild the railways. However, some key themes have emerged from our literature review and discussions with expert interviewees:

- A unified public sector train operator could greatly improve the service to passengers, whilst reducing costs presently generated by multiple mutually uncooperative operators. Passenger train operations should be brought back into the public sector at zero cost as franchises expire or fail, or at minimal cost as franchises deteriorate to weak profitability. This approach would make economic sense.
- Network Rail should be brought back under public control, which, amongst other advantages, would reduce the substantial debt service costs that it incurs as a supposedly non-governmental not-for-dividend company.
- A single overarching 'guiding mind' is needed to make sure that the railway operates as a coherent whole, in place of the current fragmented system.
- Rolling stock leasing is a hugely expensive way to obtain our trains, and a shift from 'hire purchase' to buying trains outright is needed. This shift should be accompanied by a procurement strategy that rebuilds the UK train manufacturing industry.
- Rail freight carriage on the UK rail network must continue to be open to private companies because current EU rules specify open access for freight. However, it does not appear that these companies are delivering growth of the rail freight sector and the attendant social, environmental and economic advantages that could bring. Innovations are needed to help realise this potential, including consideration of the benefits available from a publicly-owned freight operator.

These themes are explored further in the following sections.

> *"The public sector is involved in this in a massive way already, but it doesn't get a big enough public dividend. What we have got at the moment is too little of the capacity offered by the public and not-for-profit sector to make a contribution. That includes holding back our existing state operator – Network Rail – from being able to run train services. But equally I wouldn't want to go to the other extreme and say that the private sector is not welcome in."*
>
> Andrew Adonis, former Secretary of State for Transport

11.2 Unifying passenger train operations at minimal cost

It is not necessary to take a sudden 'big bang' approach to create a coherent train operator from the present chaos of mutually antagonistic TOCs. Most of our interviewees expressed the view that this would inevitably be a more protracted process. As one put it, *"British Rail was a highly efficient machine that could rip itself apart; putting the railway back together again is a different matter".*

Bringing passenger operations into the public sector in a gradual way carries the advantage that it would provide a comparator against which the performance of other operators could be benchmarked. Evidence to date shows that where train operations have, perforce, been taken back under public control, they have

significantly outperformed the preceding private franchise operators[129]. A gradual approach to taking passenger operations back into public ownership would be able to prove its worth as it progressed. The potential gains are all monitorable: lower costs; higher performance; greater customer satisfaction.

There was a range of views amongst our interviewees on whether private companies should have no role, or some remaining role, in running passenger services as part of a reformed railway. But whether the eventual end point is passenger operations entirely within the public sector or a 'mixed economy' with some continued private sector involvement, the first step – taking some passenger franchises into public control – is the same. Our proposed gradual approach offers a means to build a consensus over time, through measurement and comparison of the performance of private and public operations.

There are several possible options for gradual acquisition of franchises, none of which would entail significant public expenditure. Train operating companies could be absorbed into a public 'passenger operations' organisation as existing franchises expire, or through enforcement of franchise conditions as train operating companies fail to meet them, or as TOCs themselves choose to surrender franchises. Both the last two processes have happened in the past and arguably would have happened more often if Government had not been prepared to bail out franchisees or slacken franchise conditions. An additional option, discussed further below, is to reclaim franchises as their premium payment structure reduces their purchase value to zero or a minimal price.

Figure 11 lists the expiry dates of existing franchises. Many of the present franchises are due to be re-tendered between now and 2015, steadily reducing the number that would be automatically available for any new Government to re-incorporate into a single operator, depending upon when that Government comes to power. For the next three years it is important that opposition politicians are alive to the opportunity to achieve rapid transformation of the railway should there be political convulsions that precipitate a change of Government, but clearly it is also prudent to lay plans that can be enacted by a reforming Government taking power in 2015, which would be confronted with a very different task.

Figure 11: End dates for passenger rail franchises

Franchise	End Date
Inter-City West Coast	2012
Essex Thameside	2013
Inter-City East Coast (ICEC)*	2013
Thameslink	2013
Greater Western	2013
Transpennine	2014
Greater Anglia	2014
Northern	2014
Scotrail	2014
South Eastern	2014
East Midlands	(March) 2015

GENERAL ELECTION[#]	*May 2015*
South Central	(July) 2015
West Midlands	(September) 2015
New Cross Country	2016
South Western	2017
Wales and Borders	2018
Chiltern	2021

* ICEC currently operated within public sector
# The coalition government's term of office will end in May 2015, unless the coalition collapses before that point

Even for a Government faced with a situation where many franchises had recently been re-let, there would be significant opportunities to pursue reunification of passenger operations. Three inter-linked factors are critical to this: break points in franchise agreements; breach of franchise conditions; and the structure of franchise payments to and from Government.

Break points in franchise agreements

Franchises let since 2004 have contained performance break points[130]. The current Government's stated intention to move to longer franchises would seem to strengthen the requirement for regular break points to review performance and terminate under-performing franchises. In their consultation on franchise reform, the Government mooted review points every 5-7 years[131]. In response, the train operators opposed the idea of any review mechanism or review points[132]. The Government's resulting position is that: "We will consider inclusion of a review mechanism on a franchise by franchise basis". The important question of the scope and frequency of review points thus remains undetermined. Nevertheless, it would appear difficult to defend exposing the public finances and important public transport services to the consequences of franchises running 15 years or longer with no review mechanism whatsoever.

Breach of franchise conditions

Past evidence is that many TOCs have not fully met the terms of their franchises. In only one case, Connex Southeastern, has the Government proactively taken back a failing franchise. However, both GNER and National Express decided to walk away from East Coast Main Line franchises (and did so with insignificant financial penalties)[133]. A Government that was committed to reforming the railways would be in a stronger position than previous administrations to enforce franchise conditions, in the interests of passengers. This would either lead a TOC to comply with its contractual agreement – to the benefit of passengers – or would result in a formal breach which would enable the Government to take back the franchise.

Structure of franchise payments to and from Government

It seems probable that the (supposedly) long-duration franchise contracts that are presently under negotiation will have a similar profile of subsidy and premium payments to recent contracts. This pattern is that in the early years of a franchise, the TOC makes small premium payments to Government, or receives a subsidy; then as the franchise progresses, yearly premium payments from the TOC increase markedly. A franchise with this pattern tends to reduce profitability over time. This feature of franchises persists because bidders have a strong incentive to win the bid,

and therefore make optimistic assumptions about future passenger growth and hence future profits, knowing that they will face negligible penalties in the event of over-bidding, as they will simply be able to relinquish the franchise[134].

There is an important, and potentially more positive, consequence of a franchise system which incentivises over-bidding in this way. After the first few years, profits may be reduced to the point that the TOCs in question are in a very weak position to claim any significant recompense should the Government decide to reclaim the franchise for operation under public ownership.

This premium payment pattern contributed to GNER and National Express abandoning the East Coast mainline franchises. More recently, First Great Western has decided to take advantage of a break point in its franchise agreement and will terminate its franchise three years early. By exiting early it will avoid paying £800 million due to the Government as premium payments in the three final years of the franchise, by far the bulk of the premium payments under the whole franchise agreement, which received £150 million in public subsidy in its first three years[135]. This franchise started in 2006, began paying premiums in 2009-10, at the rate of £20 million, rising sharply thereafter, with £230 million due in the 2012/13 financial year that will now be the last full year of operation[136].

While the profile of premium payments could generate opportunities for a new Government to regain recently-signed franchises, it may also be relevant to some current franchises that are due to extend beyond 2015. South West Trains, for example, is already, in the 2011/12 financial year, contractually due to pay £133 million. By 2015, their annual payments are set to rise above £300 million (as calculated in real terms at 2006 prices), comparable to the sums that have caused other TOCs to seek an exit from their franchise obligations. Similarly, the longest franchise, Chiltern Railways, was already loss-making in the financial year 2009/10[137] and appears to face a stiff challenge as premium payments rise markedly in coming years.

As noted earlier, there is no financial cost to Government in lost premium payments if franchises are reclaimed under these circumstances.

11.3 Relationship between a unified passenger train operator and other parts of the railway

Under EU rules, a unified passenger train operator must show separate accounting from parts of the railway responsible for management of infrastructure, and the ‘essential functions’ of controlling and charging for access to infrastructure must be protected from influence by the train operator.

However, both the passenger operations functions and infrastructure management functions could and should be brought under a single overarching entity that would provide a ‘guiding mind’. For the purposes of this paper the proposed ‘guiding mind’ organisation is termed ‘GB Rail’. The ‘guiding mind’ function is discussed further in Section 11.9.

11.4 Inter-city services within a unified passenger train operator

Most countries’ rail systems show a clear structural distinction between fast long-distance inter-city services, and more local trains serving a single city or region. Long-distance services in many cases succeed in turning an operating profit (but in the context of state support for rail infrastructure) whereas local services are almost

universally subsidised (with the notable exception of Japan where there are extreme population densities and train overcrowding). Differing geographies result in variants on the more local services, ranging from urban rapid-transit networks centred on a single city hub to networks serving whole regions.

Division of routes according to franchises in Britain presently obscures this pattern, but the basic distinction is nevertheless valid. The operational and passenger requirements of services from, say, Edinburgh to Newcastle are quite different to those of services travelling into Newcastle from the city suburbs (although the distinction is blurred in other places, and there is the additional category of services that travel longer distances at rather slow speeds to link rural hinterlands with regional centres).

Our review of expert opinion found a majority view that, as part of the move to a unified passenger train operator, fast long-distance services can and should be reassembled as a single management and business unit within that operator. These fast long-distance services could provide a high-profile demonstration of the potential for a publicly-owned railway to deliver excellent passenger service. They would form a strong flagship brand for the reunified railway – perhaps even the historic but still resonant name 'Intercity'.

Public operation of these potentially profitable services would bring advantages to the public purse and to passengers. The Government could choose to direct the resulting profits towards reducing fares on long-distance routes, so that they ceased to be an 'elite-only' service, while helping to cut carbon and congestion arising from long-distance car travel. Alternatively, it could choose to cross-subsidise socially valuable rail services on other routes.

There were different views amongst our interviewees on the breadth of scope of an 'Intercity' business and management unit. One view was that it should only contain those services which are already high-speed and high-capacity, that is, the East Coast, West Coast and Great Western services. Another view was that it should include important city-to-city links that do not involve London: for example Glasgow to Edinburgh; Liverpool to Manchester and across the Pennines to Leeds and Sheffield; Norwich to Peterborough and to Midlands cities including Birmingham. The merit of this second approach is that by giving 'Intercity' status to such routes, investment in them would be encouraged. Over time, investment in these routes would enhance their quality, acting as a spur to economic development outside London and the Southeast. Initially, such services might be branded differently from the more obvious 'Intercity' routes (for example, Germany brands some services as 'inter-regional').

> *"The first step to bring the TOCs back into ownership is to recreate Intercity. Intercity is the framework about which the rest of the railway hangs. It links the regions. It goes everywhere apart from the South. You've only got Great Western; West Coast; East Coast; East Midlands. Anglia's not really Intercity now. Just four intercity lines. It's not sensible having separate TOCs running a national business with no unified ticketing, etc. You could recreate Intercity relatively easily. Franchises will be let by the time there is a new Government, and you'll have 15 year franchises, but there is no reason a Government shouldn't 'stamp around'. The stamp of Government!"*
>
> Roger Ford, Industry & Technology Editor *Modern Railways*

"You could also have an Inter-Regional Express network. InterCity is all about London, and we need an economy and a country that is not so focussed on London. So Inter-Regional might include Transpennine, Norwich, Liverpool. You could have a separate Inter-Regional brand…. or you could just make it part of Intercity."

Expert Interviewee

11.5 Relationship of a unified passenger train operator with regions and devolved administrations

Our review of experts found very broad support for the idea that devolved national Governments and bodies responsible for transport in English regions and metropolitan areas should play a greater role in the provision of passenger rail services, within the context of GB Rail as a unified passenger operator throughout England, Wales and Scotland. Local priorities for train services will sometimes conflict with national priorities for the long-distance rail network, and where capacity is limited compromises must be negotiated. For an effective outcome, bodies representing both sets of interests must have a role in determining services. An Inquiry by The House of Commons Transport Select Committee[138] found strong arguments in favour of such local involvement:

'Local and regional needs and priorities should be a central factor in the determination of rail services. These considerations must not take precedence over a national strategy, but should be integrated with it.... The removal, in the Railways Act 2005, of the statutory right of PTEs to co-sign franchise agreements was a mistake'

Involvement of local and regional bodies in provision of rail services is the norm elsewhere in Europe. Although there is a wide range of models for interactions between unified national passenger train operators and municipal or regional authorities, every other European country appears to have more devolution of control for local services than the UK.

"You can have an integrated, publicly controlled and owned national railway network, and still have lots of local devolution of specification of operations. Europe and elsewhere is full of examples. If the railways were to be reintegrated and publicly owned, we should have structures that would allow that to happen. The evidence is, on the whole, that when you do it you get more investment in more railway because local politicians can see the benefits of expansion that national politicians and officials can't. You get more trains, more services and more jobs out of it."

Stephen Joseph, Director, Campaign for Better Transport

From the European evidence, three overarching generalisations emerge:

- Bodies with specific geographical remits and accountability are best-placed to define, represent and negotiate the service needs of train passengers within their catchments, and also to arrange integration with other modes of transport such as buses, trams or tubes.
- Such bodies are more likely to succeed in achieving their aspirations for local rail services when they carry financial clout, whether they are deploying funds raised within their catchments or allocated to them from national budgets, and whether they are negotiating service provision with a single national rail operator (the

situation in France or Spain) or negotiating in the context of a single national rail operator competing against other operators (as in Germany).

- European rules make explicit provision that these types of relationship do not have to involve a competitive tender process: '*Competent authorities may decide to make direct awards* [i.e. without tender] *of public service contracts where they concern transport by rail'* [139].

It therefore seems sensible that the transition to a unified passenger operator in the public sector should be accompanied by shifting the stream of finances for local and regional rail services, so that these funds flow via local and regional bodies.

These bodies would also need to be given powers to specify local service needs in their areas, and to negotiate with the unified passenger operator to deliver these services. Such powers are already held by the Scottish Parliament and Government, which lets the Scotland franchise. The Welsh Assembly Government should be empowered to the same level as Scotland.

Within England, there is, in principle, an equally strong case that local train services should be determined by a regional representative body. However, problems arise because at present no appropriate regional bodies exist. Across much of England, county or unitary councils are the highest tier of authority with regard to local transport matters, and they are too small to be well-placed to specify local train services, which will typically run across several counties. Only some parts of England are covered by Integrated Transport Authorities, and even these in most cases cover too small an area, or one with geographical boundaries that do not match the rail network feeding their core city.

One solution to this problem might be to establish regional transport executives, answerable to groups of local authorities. PTEG explained to us their idea of a 'Northern rail executive'. This is currently under discussion in the context of the PTEs' aspirations for greater involvement in a re-let Northern rail franchise in 2014, but it would also be applicable in the context of a re-unified passenger rail operator. Such a body could cover the area of several PTEs and neighbouring counties. It would be answerable to its constituent ITAs and local authorities. Its role would be to specify local train services and negotiate with the unified passenger operator to provide them. A regional transport executive might cover an area such as the north of England (including the ITAs responsible for Liverpool, Manchester, Leeds, Sheffield and Tyne and Wear, and also local authorities including Cumbria and Lancashire), or south-west England, or the Midlands.

Reform of rail should not, however, become mired in the broader politically fraught debate about regional devolution. In the short term at least, a reformed railway must find pragmatic ways to work despite the absence of accepted regional governance structures across much of England. The most practicable medium-term option appears to be modification and expansion of the present system of ITAs and PTEs, with budgets and powers to specify local services devolved wherever strong regional bodies and devolved administrations exist. Elsewhere (and for all Intercity services) the budget and power to specify services would remain with DfT.

Taken together, London and the south-east account for a large proportion of UK rail passengers, but the dominance of London as a rail hub within the south-east region raises particular issues. Transport for London has made a success of the Overground and would like to extend its reach to include rail services feeding London,

but these services extend well outside TfL's boundaries. For these rail services, democratic legitimacy would appear to require that local authorities outside London join with the Greater London Authority and TfL to form a regional body with powers to specify commuter rail services into London.

Such a regional transport authority would appear to be strongly justified. At present, in the absence of any such regional body, the privatised railway of mutually uncooperative operators has strikingly failed to deliver the considerable gains that would accrue for passengers from such measures as region-wide smart-card ticketing and tickets valid across different operators.

Negotiations between the passenger operations body and funding bodies (i.e. Scottish Parliament, Welsh Assembly Government, ITAs or groups of authorities constituted as regional transport executives, and Department for Transport) should be programmed to cover periods that allow joined-up planning of rolling stock requirements and infrastructure changes that will affect rolling stock needs (e.g. electrification). This would most sensibly mesh in to the same 5-year-plus rolling plan as is proposed for infrastructure planning (see Section 11.7).

11.6 A more accountable and cost-effective structure for Network Rail

Network Rail was established in 2002 as a 'not-for-dividend' private company, in order that the substantial debt it inherited from Railtrack did not have to be brought onto the Government's balance sheet.

As discussed in Section 2.2, interest payments on this large (and growing) debt consume a major proportion of the public subsidy that Network Rail receives every year. Because this debt is attached to a private company with less financial credibility than the Government, interest payments consume significantly more public money than if Network Rail were a public body. It is estimated that over £150 million of debt interest payments could be saved every year simply through bringing Network Rail into the public sector.

Some of our interviewees, and other commentators, have argued that the off-balance sheet nature of Network Rail's debt is anomalous, as the Government ultimately bears the risk[140]. None of the interviewees considered it remotely possible that Network Rail could pay off its debt. The Government manoeuvres to avoid treating Network Rail debt as public debt were viewed as 'sleight of hand' and there was consensus that the debt must, inevitably, be taken onto the Government's books eventually, and that this is best done sooner rather than later, since its continuation is an ongoing burden to the railway and obstacle to investment.

The private company status of Network Rail (albeit not-for-dividend) has resulted in a peculiar and arcane governance structure which means that neither Government nor anyone else can exert effective control over what its directors do. Amongst other criticisms of its structure is the incestuous system whereby Network Rail's board is supposedly held to account by 'members' who are chosen by a subcommittee of the board itself[141]. Although Network Rail is in receipt of considerable public funds, it has very inadequate accountability to government for how it spends that money.

The solution to this accountability gap is for Network Rail to become a division or subsidiary of a publicly-owned 'guiding mind' organisation, which we have termed 'GB Rail', and for that 'guiding mind' organisation to have a structure which is

properly accountable to government. The nature of that structure is dealt with further in Section 11.12.

11.7 Infrastructure planning on a five-year-plus cycle

While the status of Network Rail should change, our interviewees felt strongly that the present five-year planning / finance cycles for rail infrastructure investment (control periods with agreed programmes of planned investment described by high-level output specifications) should be retained. This system was seen by all interviewees to offer advantages relative to the stop-start funding and end-of-financial-year spending scrambles that occurred before privatisation.

> *"One really big risk to avoid, is going back to a situation where government says in November, 'right we're taking £20 million out of your budget'. Stop-start financing. Or the junior transport minister negotiating child fares on Network SE. That kind of stuff. The 5-year plan can act as a bit of a barricade between the Treasury and the railway. So keep the whole HLOS architecture and apply it to the whole railway, not just the infrastructure side."*
>
> Stephen Joseph, Director, Campaign for Better Transport

The five year planning cycle could, however, be improved by setting it within a longer term strategic plan. Because each spending cycle entails an extended period of negotiation it generates a lengthy period of uncertainty which produces a degree of paralysis. As one expert put it, *"The five year planning cycle is pretty malign".* In addition, five years is very short compared to the life expectancy of new rolling stock and the timescales for major infrastructure projects (or indeed the intended length of forthcoming franchises, although that is not relevant to the purposes of this report). For example, some rolling stock purchase decisions currently have to be made in ignorance of whether the railway that the stock will run on will undergo changes crucial to the rolling stock specification, such as electrification.

A longer investment planning cycle of 15 years or more would help to resolve such problems, but the five-year electoral cycle precludes firm spending commitments over this timescale. One solution would be to have both a five-year and a 15-year planning horizon: that is, detailed negotiations every five years to adjust and confirm spending commitments, within the context of a strategic rail plan stretching out 15 years (at least). A 15-year strategic rail plan could be revised on a 'rolling' basis, for example every 7-8 years, so that there would never be a hiatus between successive plans. It would be the outcome of a political process to agree a vision for the future of Britain's railways, shared across political parties and regional / national authorities. Longer-term political discussions of this type already happen in relation to high-speed rail, but other strategic issues – for example, how inter-city services should be developed outside London – are currently neglected. This imbalance could be redressed by a 15-year strategic rail plan. The purpose of the detailed five-year planning cycle would then be to decide which elements of the vision could affordably be realised during the immediate future, given economic circumstances and other considerations.

This 'five-year-plus' approach would enable efficient planning and delivery of new infrastructure. It would also assist the efficient procurement of new rolling stock, since train manufacturers could confidently plan investment and staff requirements whilst also having an opportunity to apply lessons from production of the first batch of each new stock design to subsequent batches.

11.8 Regional and devolved bodies' input to rail infrastructure investment

The Scottish Parliament and Government already control funds for the rail infrastructure five-year plan, the Scottish High Level Output Specification. This should continue for the 'five-year-plus' planning advocated above. The Welsh Assembly Government should be empowered to the same level as Scotland. The present HLOS process for England and Wales would therefore be replaced by 'five-year-plus' infrastructure planning for England alone. There should, however, be duties placed on the UK, Scottish and Welsh Governments to work with each other and Network Rail's successor to ensure coordination of infrastructure planning and investment for cross-border routes.

Within England, regional transport bodies (ITAs or the regional transport executives outlined in Section 11.5) should have a role in determining regional priorities for infrastructure investment, as part of the 'five-year-plus' planning process. There is also the potential for these bodies to fund regional rail improvements, rather than all such funds coming from central government. This could be from existing sources of funding, or from new local revenue-raising powers.

Local revenue-raising powers have played an important role in improving local and regional rail services in some other European countries. For example, the 'versement transport' was introduced in Paris in 1973, and has been expanded to other localities as a result of its success. It started as a fund for infrastructure but subsequently has become important in supporting operating costs, now meeting an average of 44% of operating costs in the areas where local transport authorities levy it.[142] The renaissance of light rail in France has in large part relied upon 'versement transport' funding. The 'versement transport' is collected from businesses as a percentage tax on their total salary bill that ranges according to region from 0.6% up to 2.6% in Paris. It raises about €3 billion in Paris[143] and over €100 million in Lyons, a city equivalent in size to Liverpool[144]. It applies to businesses with over nine employees, with introduction tapered over three years for businesses that grow past the threshold.

From a transport perspective, 'versement transport' seems greatly superior to the business rate supplements that English and Welsh local authorities can, in theory, create under the Business Rate Supplements Act 2009. 'Versement transport' is dedicated to public transport; it is not just temporary; and there is no limit to the proportion of a public transport scheme's costs that can be covered. It covers both operating and infrastructure costs, which is important because British local authorities tend to have capital budgets for new public transport infrastructure which are not matched by revenue budgets to support the services to use that infrastructure (what the House of Commons Transport Select Committee termed the 'capital-rich revenue-poor' problem[145]). It is not subject to a difficult referendum hurdle before it can be introduced, and it is more acceptable than the business rate supplement to small businesses, who are exempted then eased in gradually as they grow.

11.9 An overarching 'guiding mind' for the railway: GB Rail

So far, we have examined reforms to passenger train operations, and reforms to infrastructure management, but have not considered how these two halves of the railway might be fitted back together. This need for the different parts of the railway to be managed as a coherent whole arose repeatedly in our discussion with experts, several of whom pointed to the need for a 'guiding mind' to ensure that services,

infrastructure and rolling stock are managed and developed in an integrated and consistent way.

It may seem that such integration of passenger operations and infrastructure management would be difficult to achieve within the context of EU law. However, a careful assessment of the structural arrangements in other EU countries, and the specific grounds on which the European Commission has challenged these structures, suggests that substantial integration under an overarching 'guiding mind' would be possible. In this section, we examine the situation in other EU countries in some detail, and then suggest what options might be open to Britain.

Our review of other European countries revealed a variety of situations regarding the 'guiding mind' function. At first sight, France, the Netherlands, Sweden and Spain, all of which have separate companies for infrastructure and train operations, appear to operate without a 'guiding mind' organisation. In the Netherlands and Sweden this is the result of a degree of enthusiasm for rail privatisation, and in both cases the separation of infrastructural and operational functions and absence of a 'guiding mind' has caused some of the problems experienced in Britain.

Despite creating separate companies for infrastructure and operations, France has ensured that these are coordinated, so as to obtain the effect of a 'guiding mind', by contracting back most infrastructure management to SNCF, the train operator. Although this structure offers some lessons for Britain's railways, as presently constituted in France it would appear to be difficult to justify under EU rules because the contracting-back arrangement to SNCF includes the 'essential function' of determining access to infrastructure that EU directives specifically seek to make independent of train operators. Accordingly, the European Commission has made an official complaint that France is in breach of the EU Rail Directive requirement that 'functions determining equitable and non-discriminatory access to infrastructure [must be] entrusted to bodies or firms that do not themselves provide any rail transport services'[146]. There are ways that the French can address this complaint, but their current framework does not appear to give them obvious options to do this without severe problems – loss of the 'guiding mind' function, or handing it back to Government, which is exactly the European Commission's legal complaint against Spain.

In Spain, a 'guiding mind' exists despite separation of infrastructure and train services, because the railway structure involves close relationships between the railway operations company, the rail infrastructure company and the Ministry of Transport. Whether the Spanish Government can continue to exert a 'guiding mind' function in this way is in question, because it is being challenged by the European Commission on the grounds that it is in breach of the EU Rail Directive requirement that 'as regards management...railway undertakings [must]...have independent status [of Member States]'[147]. So, although it should not be ruled out as a structure, the problem for Britain in adopting the Spanish model would be the difficulty of retaining a 'guiding mind' function for the whole railway at a (legally) acceptable arms-length from Government without any overarching body spanning both trains and infrastructure. This is exactly the situation that seems to have created problems and dissatisfaction in the Netherlands and Sweden, albeit to different degrees.

In Switzerland, infrastructure management and train operations form divisions of a single company. Although this could be considered as an option for Britain, it

appears rather difficult to defend against EU requirements for access to infrastructure to be managed by 'bodies or firms' that do not themselves provide rail services[148].

That defence would seem to be more easily mounted in cases like Germany or Italy where separate legal corporate entities are responsible for infrastructure and trains. With their structures, however, a 'guiding mind' function is still obtained in the form of an overarching corporate group that unites both the infrastructure and train companies.

The degree of separation within this type of structure has been challenged by the European Commission, but accommodating the Commission's concerns within this structure appears to be more feasible than in the case of the French or Spanish structures. The Commission's grounds of dispute with Germany are that there are '*insufficient* [our emphasis] safeguards to guarantee the independence of the infrastructure manager from the railway holding and its transport affiliates in the exercise of the essential functions [to provide fair access to rail infrastructure]'[149]. Indeed, the European Commission's lawyers in the ongoing case against Germany in the European Court of Justice appear to have conceded that the established corporate structure, with trains and infrastructure run by legally separate corporate subsidiaries of a single parent company, has the potential, with 'appropriate and adequate precautionary measures' to meet the requirements of the EU Rail Directive[150].

It is not yet evident to what extent Germany and Italy might agree to modify the internal rules and structures of their rail companies so as to put extra safeguards in place, but the sort of precautionary measures cited by the Commission lawyers appear relatively straightforward. The measures cited are:

- Prevention of shared directors and 'revolving doors' appointments between the parent company and the subsidiary company responsible for 'essential functions';
- Separation of staff, premises and information systems;
- Legal duties on the subsidiary company managers to act independently;
- Supervision of their independence by an independent authority.

Considering these disputes in relation to the options they suggest for Britain's railway, it is important to note that EU directives are not concerned about which body should be responsible for the maintenance or upgrade of rail infrastructure or day-to-day functions such as signalling or station management. Indeed the directive appears to recognise that some of these functions may logically and usefully be carried out by a train operating company (rather than the infrastructure manager) and makes explicit allowance for this[151].

Rather, the EU laws are directed at ensuring that *access* to infrastructure is controlled in a way that is non-discriminatory to the commercial train operators to whom the directives give rights of market access (i.e. freight and international passenger operations), both in terms of allocation of capacity on the rail network, and charges for access. These are the so-called 'essential functions' that the Commission is concerned to ensure are independent of train operating companies, who have a vested interest in controlling network access.

Viewed from the UK perspective, some useful possibilities are raised by the explicit recognition in the EU directive that these 'essential functions' may be located in a

structurally independent body in charge of access in cases where the remainder of infrastructure management (infrastructure maintenance and enhancement, signalling and station management) is structurally combined with train operations[152].

In the following sections of this report, we set out how this option might be achieved in Britain, with a single 'guiding mind' parent corporation spanning a subsidiary company responsible for passenger operations, infrastructure maintenance and enhancement, signalling and station management (which we term 'GB Rail Network and Operations'), and a separate subsidiary company responsible for the 'essential functions' in relation to capacity allocation and access charges (which we term 'GB Rail Access'). This arrangement would provide the 'guiding mind' to coordinate railway functions (and to act as a single railway entity that national Government can deal with), whilst also meeting EU requirements for an arms-length relationship with Government and independence of the 'essential functions'.

A structure of this kind, if applied to Britain, seems likely to result in the least friction with EU rules, with flexibility about how to meet them in detail. However, this model should not be regarded as the only possible choice. Judging from past form, other EU countries would appear likely to find innovative modifications to their present rail structures so that they can survive the Commission's push to fragment them for many more years.

11.10 Relationship of an overarching body to central Government

Three broad points emerged from our discussions with experts regarding the relationship between the Department for Transport and an overarching 'guiding mind' body for the railway:

- Strategic Government input is essential to set out what we want of our railways in the medium to long term and to represent the interests of public finance.
- Government needs a coherent railway organisation to deal with. At present, the Government's ability to provide strategic direction is severely constrained by the fragmented state of the railway and the commercial freedoms given to various parts of it for both operational and strategic decisions.
- While Ministers and officials should have a strategic role, the Department for Transport should not micro-manage the railway. It should be the job of expert executives to manage the railway, maximising operational outputs whilst exerting control over costs.

An overarching body acting as a 'guiding mind' for the railway – 'GB Rail' – would provide a single organisation for Government to deal with. It would work with Ministers and officials to develop the strategic plan for the railways, identifying long-term spending priorities. It would then manage the railway as a coherent whole, coordinating train operations and infrastructure, so that both day-to-day management and longer-term decisions accorded with the strategic direction set by Ministers. Because it would have an overview of the whole railway, it would be able to achieve efficiencies which are not currently possible: notably, it would be able to plan new rolling stock procurement and cascading of older stock for use on other parts of the network, which has been a striking failure of the present fragmented system.

In the German model, the Federal Government exerts influence on Deutsche Bahn via several mechanisms. It is sole shareholder, which amongst other powers means it selects and appoints a majority of representatives to Deutsche Bahn's 12-person

supervisory board (a board of non-executive directors with powers to appoint the management board of Chief Executive and other executive directors, and to oversee the strategic direction and financial management of Deutsche Bahn[153]. The Federal Government itself has three seats on the supervisory board, presently held by senior officials from the three ministries of transport, finance and economics. The Government also negotiates a series of 'performance and financing agreements' with Deutsche Bahn in return for allocating Government monies. However, the relationship is also partly defined by primary legislation: for example, the German Constitution stipulates that Deutsche Bahn must be managed according to commercial principles and also specifies certain financial obligations to the railway that the Government must fulfil.

One obvious advantage of the Deutsche Bahn structure is that by splitting the 'management board' of the company's executive directors from the 'supervisory board' of non-executive directors who hold ultimate power and exercise strategic oversight, it enables representation of a wider range of interests than the conventional British company board, where executive and non-executive directors serve together.

Although the Deutsche Bahn structure is unlike most British commercial businesses, it does resemble the structures of some not-for-profit organisations in the UK, where governance arrangements must span a range of interests. For example, charities such as the National Trust and Scope have an entirely non-executive board of trustees who oversee a management board of executives, with the non-executive board selected via an electoral college process so as to ensure different stakeholder groups are represented. A variant on this is the BBC, which also has a non-executive body, the BBC Trust, which has certain powers over the BBC Executive Board, although in this case all members of the BBC Trust are appointed by the Secretary of State, and the Executive Board is a mix of non-executive and executive directors[154].

We believe that a governance structure similar to the German one would be worth considering for GB Rail. It would offer a simple, proven and well-understood corporate decision-making model, learning from both the continental corporate sector and the UK not-for-profit and mutual sector, and it could enable representation of the various constituencies that have a legitimate interest in the railway, including Government as the principle funder, passengers and employees.

11.11 Relationship of an overarching body to devolved governments and regions

In Sections 11.5 and 11.8, we made the case that regional bodies and devolved national Governments should have a strong role to work with the nationwide GB Rail body to specify local passenger train services and infrastructure priorities for their areas, and that funding for local rail services should flow via these bodies.

There remains a question of whether these bodies should have some additional role in the 'guiding mind' rail body. Individual representation of each of the potential regional authorities and devolved nations would lead to an over-large cumbersome board, even if a Deutsche Bahn style 'supervisory board' of non-executive directors was distinguished from a 'management board' of executive directors. An alternative would be for one or more representatives of regional and devolved national bodies to sit on the supervisory board.

"I think you could put people into the board as non-execs, who might come from unions, passenger groups, local authorities. But there's two [different] things that you want:

a) people to run the railway, with really good management, who ought to be people who are involved in the railways themselves;

b) people who reflect wider stakeholders."

Stephen Joseph, Director, Campaign for Better Transport

11.12 Relationship of an overarching body to railway passengers and staff

The Deutsche Bahn supervisory board is evenly split between members elected as employees' representatives and members representing 'shareholder' (that is, Government) interests, with the latter holding the chair and therefore the casting vote. This level of employee representation is obligatory for large German companies under the German 'Co-determination Act'. The structure is a manifestation of a tradition of managing industrial relations that is quite different to Britain's, but given Germany's industrial success it offers a relevant model.

John Lewis is structured so as to guarantee a similar employee presence on the company board, with five elected employee representatives out of twelve in total[155]. John Lewis describes its structure as 'shared employee ownership', but it might more usefully be termed a democratically-organised profit-sharing company: its employees cannot sell their shares because they are all held in a trust, and so all they receive from the shares financially is a yearly bonus payment.

Both these examples offer a model for employee representation at the board level of GB Rail. It would be appropriate if, as in Deutsche Bahn, such board members were drawn from unions that represent staff (John Lewis does not recognise unions).

A 'GB Rail' non-executive supervisory board might also be constituted to include passenger representation. One of our interviewees felt that passengers' interests are better represented by an outside body, such as Passenger Focus, but other interviewees felt that democratic involvement of passengers was a vitally important aspect of public transport governance.

"An important point for us is that the travelling public deserve a properly accountable railway. The democratic governance of a mutual or co-op means that members are – and feel that they are – in control. We did a poll with YouGov which showed that 81% of the travelling public felt that they didn't have enough say in how public transport is run."

Joe Fortune, Parliamentary Officer, Cooperative Party

Defining a practicable electoral college for passenger representation is not entirely straightforward. However, season ticket holders, who in essence purchase a stake in the railway every year, are a category of travellers that merit a vote and that are registered with train companies with a unique reference that could be used as the basis for a voting system. It would be beneficial for the supervisory board to also include disabled travellers, for which disabled people's organisations could be invited to appoint or to act as an electoral college.

11.13 Overview of the proposed unified structure

Figure 12: A possible governance structure for GB Rail

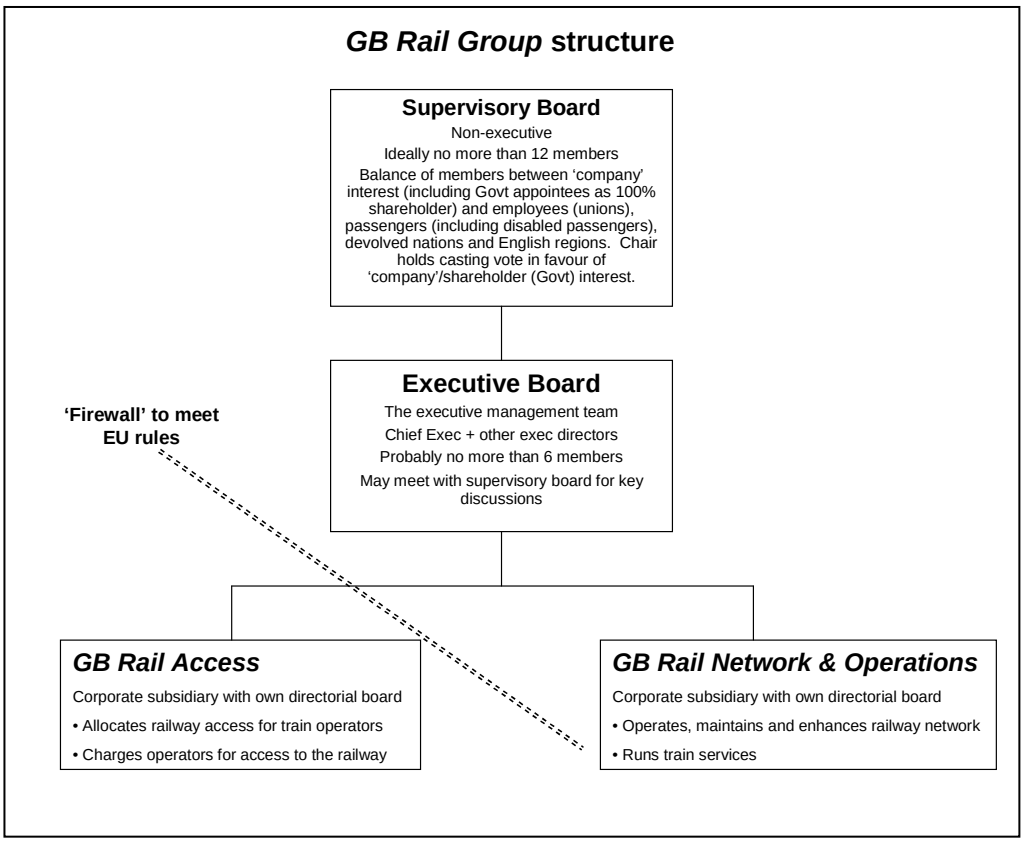


Figure 12 schematically presents a possible governance structure for GB Rail, derived from the Deutsche Bahn governance structure but modified to give broader accountability in the ways discussed above. Whilst deriving from a corporate model and retaining the simplicity that offers, this structure bears resemblances to structures found in mutuals, cooperatives and not-for-profit organisations, all of which also have to reconcile management for financial and operational rigour with accountability to a range of stakeholders.

The schematic also shows an important feature required to meet EU law - the need for a 'firewall' around the GB Rail Access subsidiary. This firewall is required to protect the 'essential functions' of impartial allocation of access to infrastructure and access charging. From the dispute between Germany and the EU Commission (as discussed in Section 11.9), this firewall would involve rules to prevent sharing of directors and 'revolving doors' appointments; physical separation of staff, premises and information systems; legal duties on the access company managers to act independently; and supervision of their independence by an independent authority.

The split of operational staff within the subsidiary companies should be such as to retain the maximum coherence of the overall railway operation and cut out the multiple inefficient interfaces that have built up in the privatised railway. To this end, GB Rail Network and Operations should carry out all other functions than the 'essential' access functions. These functions should span both running train services and operating and maintaining the railway network. Combining these functions within one organisation creates the easiest possible channels for staff such as signallers,

maintenance workers and train drivers to communicate and work together without obstruction by organisational divisions. In this respect, the structure proposed here might be seen as combining aspects of the German system with some of the best aspects of the French system.

To achieve greatest coherence of day-to-day operations the functions of GB Rail Network and Operations should ideally extend to traffic control, a function that carries the potential to bear in on the 'essential functions' of access to the network. However, the specific requirements in the EU rules generally pertain to procedures for long-term multi-year access agreements rather than day-to-day traffic control. It may therefore prove possible to achieve adherence to the EU rules through ensuring, via the powers of the rail regulator or otherwise, that these agreements are adhered to in the workings of traffic control on a day-to-day basis without those functions actually being located in GB Rail Access. The Directive does provide that ad hoc requests for train paths should be dealt with as soon as possible and at a maximum, within 5 days[156], so GB Rail Access must have systems in place, involving traffic controllers where necessary, that enable access to the network under these circumstances.

The other 'essential function' of GB Rail Access is to establish and collect charges for access to the rail network. This raises the question of where ownership of the network should reside and how to meet the EU requirement that railway infrastructure must have separate accounting to train services. GB Rail Network and Operations would need to keep independent accounts for its work managing the network and its work running trains, which carries implications for its internal organisational structure. There would also need to be a cross-charging system whereby GB Rail Access pays GB Rail Network and Operations for network management tasks and whereby track access charges for train operations flow the other way. Under these circumstances there is a logic to network ownership residing with GB Rail Access.

11.14 Moving to a unified structure from the present situation

A helpful feature of the model emerging from the analysis in the previous sections is that it is probably close to the path of minimal possible disruption starting from the present situation with Network Rail as incumbent infrastructure manager. Its 'essential functions' of allocating and charging for network capacity would need to be hived off to GB Rail Access, but otherwise its current network operations could continue largely intact.

The accountability deficit of Network Rail, as discussed in Section 11.6, would be tackled by making it a corporate subsidiary of the GB Rail Group, which would have accountable governance arrangements along the lines described in previous sections.

Thereafter, the organisational changes to Network Rail centre around building its capacity to run train operations. If this process were taking place now, Directly Operated Railways might offer a convenient publicly-owned vehicle to draw into GB Rail Network and Operations, but the likelihood is that these skills and experience will be lost when the Government retenders the East Coast Main Line franchise and so will have to be rebuilt.

11.15 A new model for rolling stock procurement

The majority of our expert interviewees felt that the present system for obtaining new rolling stock via leasing companies which enjoy a largely monopolistic market position was unsatisfactory and should be ended.

> *"I don't see better value from ROSCOs making procurement decisions, on the contrary I think you actually need a joined up integrated view of procurement."*
>
> Andrew Adonis, former Secretary of State for Transport

In procuring rolling stock for Thameslink and IEP, DfT has, arguably, already moved away from the ROSCO procurement route. However, the approach it has adopted, in which train manufacturers bid for contracts to finance, deliver and maintain trains, is equally problematic. It requires train manufacturers to secure finance, at higher interest rates than for government borrowing, and in the case of the Thameslink contract it had the highly undesirable effect of putting the UK's last remaining train manufacturer, Bombardier, at a severe disadvantage against the superior credit rating of Siemens. This unfortunate approach to procurement financing is being continued with the Crossrail tender issued in early 2012[157].

Instead of this approach, 'GB Rail' should be able to procure new trains directly, using either government grant or government-backed debt.

A unified railway under a 'guiding mind' organisation would be able to plan a regularised programme of procurement to meet predicted rolling stock needs and strategic plans for the future of the railway. This would offer better value for money than the current arrangements, because 'moderated' procurement (a planned steady programme of orders) allows manufacturers to learn the most efficient way to assemble a new design of train in the early stages of production, and apply that learning to future stages. With technologically complicated products like new trains there is a significant learning curve as they are put into production: the most efficient way to assemble a new design of trains can only be fully worked out from practical experience gained from actually doing it. Bombardier[158] has indicated that 10% savings are available from 'moderated procurement'; The McNulty Review puts the saving at 10-20%[159].

Savings could be enhanced by standardising stock across the UK instead of adopting different specifications for various routes, franchises and TOCs. The McNulty Review estimates that orders of less than 200 vehicles incur a cost premium of 20-60% because the learning curve is not fully exploited.

11.16 Support for domestic train manufacturing

Procurement of rolling stock by 'GB Rail' should be carried out in such a way as to support and rebuild the imperilled remnant of the UK train manufacturing industry.

In Section 5.1, we noted that other countries in Europe procure rolling stock in a way that supports domestic train manufacture. Procurement takes account of broader considerations, such as the impact on unemployment, as well as cost.

An approach to procurement which supported UK train manufacturing industry could be consistent with EU legislation, if it was appropriately framed. The European Directive concerning procurement in the transport sector, in the process of being updated, permits Member States to introduce social (and environmental) considerations into procurement contracts[160]:

'Contracting entities may lay down special conditions relating to the performance of a contract, provided that they are indicated in the call for competition or in the specifications. Those conditions may, in particular, concern social and environmental considerations.'

The preamble to the draft Directive[161] explicitly says that these conditions may include 'the fight against unemployment'.

There is a direct tension between tackling unemployment in a particular place or country, and words in the same clause that require performance conditions to be linked to the subject matter of the contract, and not to be directly or indirectly discriminatory (between firms or countries). However, a guidance document from the European Commission[162] itself cites as good practice Basque regional government guidance that requires contracts to include 'special performance clauses', one of which has the aim 'to fight unemployment'. Clearly this regional government in Spain applies social conditions to contracts in such a way as to support local jobs, without being in breach of the Commission's non-discrimination rule.

The UK Government's 2012 Command Paper envisages only a minimal role for Government in procurement, which it proposes should be led by the TOCs, despite the abundant evidence that this approach has failed. Nonetheless, it is of note that the Command Paper does in theory see legal scope for a government to procure in such a way that *'bidders will be required to set out how they will establish a local presence to manage the delivery of the contract and be asked to make clear which elements of the contract will be sourced in the UK'*[163]*.* There are some signs in the Crossrail procurement tenders issued in 2012 that this approach may be put to the test, both in terms of this 'local presence' and sourcing, although it would appear that DfT lawyers have advised that only the local presence can be a required criterion, whereas the requirement for sourcing can only ask for specification of where elements will come from and for reports on how this is being fulfilled[164].

The same draft EU Directive includes a provision that the winning tender may be chosen on the basis that it is the 'most economically advantageous' rather than lowest cost[165] and a provision to set conditions about life cycle costs including external costs. These provisions are caveated and would require the UK to test them with particular contract conditions, but they appear to offer significant scope for conditions that a domestic manufacturer and domestic supply chain could fulfil better than an overseas competitor.

This is not a clear-cut area of law and comes down to individual cases in the European Court of Justice. It *is* clear that other countries have done much better than the UK at defending their domestic jobs and industries, by pushing the boundaries of the law.

> *"Every train that runs in France is built in France; 97% of trains that run in Germany are built in Germany; 90% of trains that run in Spain are built in Spain."*
>
> Bob Crow, General Secretary RMT

It seems highly unlikely that politicians in any other country in Europe with a domestic train manufacturing industry would have failed to find ways to award the Thameslink contract to a domestic manufacturing facility. The UK should adopt a similar approach.

11.17 Fair lease costs for existing rolling stock

Even if new train purchases are contracted directly from train manufacturers, existing rolling stock owned by the ROSCOs will still be needed for the remaining useful life of the stock.

It is important to overcome the longstanding problem that ROSCOs are able to charge excessive rents for their trains, in a market where there is very little effective competition. This has been an issue since the ROSCOs were first formed. Changes to the operation of the rolling stock market to reduce abuse of market power were recommended by the ORR in 1998 and again by the Strategic Rail Authority in 2003. Despite these changes, analysis by DfT in 2004 concluded that rolling stock leases did not provide value for money, but an effort to negotiate lower lease costs was unsuccessful. In 2007, the ORR investigated the rolling stock lease market again, and identified 11 features that prevented, restricted or distorted competition: these included the fact that rolling stock was often specific to particular routes and services; the lack of a pool of surplus rolling stock (with only 1-2% of each ROSCO's vehicles being 'off-lease' at any one time); the costs of transferring stock; restrictions within franchise invitations to tender, which meant that about two-thirds of the stock being operated in 2007 had been specified by DfT; and the fact that train operators anyway had little incentive to negotiate over price because the cost of leasing rolling stock was passed through to the Government in subsidy or premium payments.

A subsequent Competition Commission inquiry[166] agreed that there is a problem with the procurement of rolling stock, but – as with previous attempts to tackle market failure by the ORR in 1998 and the SRA in 2003 – put forward very limited remedies. However, one Commissioner was sufficiently concerned to issue a dissenting note in this regard[167]:

'With respect to the next franchising round from 2009 to 2018 when the great majority of rolling stock currently in use will be exposed to re-franchising...As a result of the lack of the competitive constraints which would exist in a well-functioning market, I think it is likely that there will be a very considerable diversion of public resources from investment in the railway system to paying for increases of prices for used stock which lack any cost justification and will simply go to increase the margins earned by the ROSCOs and therefore their profitability.'

Amongst the options considered by the Competition Commission for control of the leasing market, one option – the control of lease rentals at a 'fair' price – has the potential to be highly effective. It was rejected because the Commission felt the complexities of the leasing market were so great that it would be unworkable to determine a fair price in a timely way in the context of regular franchising rounds.

In the very different context of a reformed railway, without regular rounds of franchising, control of lease rentals could offer an effective tool to ensure existing rolling stock is available at a reasonable price. A new Government could propose a reduction in lease rentals in return for a usage guarantee on the ROSCOs' stock, and, if no agreement were reached, it could introduce regulation to control lease rentals, with an independent expert determining a fair price for the remainder of the life of the stock. Having assessed the evidence on this point, even the generally non-interventionist McNulty review[168] concludes that *'If there continue to be problems with re-lease rates...the DfT should consider introducing regulation of fair rates of return to the ROSCOs.'*

Of UK Members of Parliament who responded to an online survey inviting their comment on this issue, over half (56% of 62 respondees) indicated that they considered that 10% or less should be set as a maximum level of profit for ROSCOs[169].

11.18 A growing rail freight sector

The context for reforms to improve rail freight is quite different to that for passenger operations because competition in this sector is required under EU law. All freight operators except one, DRS, are in the private sector. DRS, or Direct Rail Services, is a wholly owned subsidiary of the Nuclear Decommissioning Authority and is therefore formally within the public sector, although it appears to be managed exactly as it would be if it were a private company. As well as transporting nuclear material, it competes with other freight operators in the intermodal market, where it has a market share of over 10% of freight moved[170].

The private freight operators are profitable companies and therefore could be expensive for the Government to purchase, should it so wish. Since any freight operator who was bought out is guaranteed a right under EU law to re-enter the UK rail freight market, it is unclear what purchase might achieve.

There was a sense from the majority of our interviewees that the post-privatisation rail freight industry has in general terms worked better than passenger operations. Interviewees identified several respects in which support for rail freight is greater now than in the days of British Rail. There was a sense that freight is no longer 'the poor relation', in terms of access to the rail network; and interviewees welcomed efforts to develop a strategic rail freight network, with investment in infrastructure schemes that are geared to the rail freight market. There was also recognition that low track access charges for freight trains make it easier for rail to compete with road haulage, and that consequently there is now a more positive climate for rail freight than existed under British Rail in the period immediately before privatisation.

> *"In 1993 freight traffic was being chucked away because it didn't make an 8% return on capital. It was 'get rid of that traffic, get rid of this traffic'. If it wasn't making an 8% return on capital, looked at in isolation, chop, chop, chop, get it ready for privatisation. So rail freight was at a really low ebb and it could only go up."*
>
> David Spaven, Principal, Deltix

> *"The biggest issue for freight is battling for its fair share of the network in terms of capacity and day to day performance – it's being seen as an equal user of the network, and not second class behind passenger operations."*
>
> Expert interviewee

> *"There has been some serious investment in capacity, so you can get large containers out of Felixstowe and Southampton – loading gauge increases – and there is clearly potential for more of that. Freight is an instance where you can say that the alternative to some big road schemes is rail – A34, A14 out of Southampton and Felixstowe respectively – if you get an appreciable upload in rail freight share out of those ports you get big impacts on traffic and congestion on the roads."*
>
> Stephen Joseph, Director, Campaign for Better Transport

While acknowledging these positive aspects of the current regime for rail freight, several interviewees pointed out ways in which the current arrangements make it more difficult to achieve a shift of freight from road to rail, or cause unintended environmental harm. As noted in Section 4.2, some strategic freight network infrastructure schemes do not happen because of the prohibitive cost to Network Rail of outsourcing rail enhancement projects to private contractors. And although low track access charges should be beneficial in shifting freight from road to rail, there are instances where they may have been 'banked' by operators as increased profits rather than being used to generate new business, and also evidence that they benefitted energy companies with coal-fired power stations at the expense of cleaner energy.

The reforms that we outline below for the rail freight sector are more limited than for other parts of the railway. They focus on how to achieve maximum benefit for the public money invested in rail freight, and in particular how to achieve a shift of freight from road to rail.

First, expansion of rail freight will continue to require public money to improve key rail freight corridors and other rail freight infrastructure, as well as to subsidise market development of less easily handled loads. This investment must address the pressing need for more inland rail freight terminals that enable the transfer of rail freight to other modes of transport for the beginning or end of its journey.

Freight has already seen a programme of infrastructure investment drawing on UK and EU monies and this is likely to continue in the next control period[171]. In Scotland there is also a programme of freight facilities grants. The trend within Network Rail for more infrastructure renewals and enhancements to be carried out by its own workforce (rather than being outsourced) could reduce the cost of some freight network infrastructure enhancements, and make viable some schemes which are presently unaffordable.

In a unified railway with passenger operations under public control but freight operations largely in the private sector, a system of track access charges would remain. However, the charging structure should be reformed, so that companies pay the true cost of their loads where these are not vulnerable to transfer to road (notably for coal, but also possibly for aggregate and nuclear train loads). This would bring immediate environmental gains by stopping the undercutting of cleaner forms of electricity generation. Low track access charges should be preserved for intermodal and other loads, to enable rail freight to compete with road haulage. The Government's 2012 Command Paper on rail indicates that this approach may already be under consideration, with ORR looking at 'scope for mark-ups on Network Rail track access charges for freight trains (for example, those serving the nuclear and coal industries)'[172].

Some of our expert interviewees suggested that DRS, which is anyway a publicly-owned freight operation, should become a division or subsidiary of the 'GB Rail' guiding mind organisation. This approach would provide a public sector comparator, working in fair competition with private operators, and taking advantage where possible of systemic efficiencies (e.g. depots with drivers that can operate across passenger and freight routes). It would reduce the risk of large private freight operators extracting excessive dividend payments from low track access charges, and encourage them to price competitively.

Bringing DRS into the publicly-owned 'GB Rail' group would be permitted under EU rules, so long as there was separation of accounting from passenger rail operations: the 'Recast' Directive dictates this separation in order that no public monies received for passenger operations are used to subsidise freight operations[173].

Growth in rail freight would also be aided by wider pricing policies to redress the competitive advantage of road haulage. In Switzerland, an HGV tax has encouraged a shift of freight to rail, and has also provided revenue for investment in increased rail freight capacity on the relevant routes. Although the UK does not experience the same extreme levels of international HGV through-traffic, some strategic UK arteries carry very high HGV loadings, and modelling has shown that a moderate HGV charge would cause transfer of a significant proportion of road freight to rail[174].

> *"If you want to do rail freight good, go for road pricing. Bingo, success overnight, and it doesn't cost the taxpayer a bean, does it?"*
>
> Expert Interviewee

Interestingly, UK road freight hauliers themselves might actually benefit from an HGV tax, if it were structured to put an end to their major problem of under-cutting by European hauliers, who presently can operate into the UK without paying UK taxes. An HGV tax levied per mile could accomplish this within EU rules.

Finally, it is important that local planning authorities, economic development agencies and the rail industry work together to spot opportunities where new rail freight terminals or other freight facilities could open up new markets. One of our interviewees pointed to a number of examples where opportunities to expand rail freight were missed because of a lack of joined-up thinking between development agencies and the rail industry at a local level. Several interviewees pointed to recent planning battles for freight interchange facilities, such as that proposed at Radlett, as evidence that the planning system did not give sufficient weight to the benefits of new rail freight developments in taking lorries off the roads and reducing carbon, and that these factors should weigh more heavily in planning decisions by local authorities and at public inquiry. As one put it, "What is the point of putting freight on the rails if you can't get it off anywhere near its destination."

11.19 Implications for rail regulation

Finally, there is a question of the role of the Office of Rail Regulation if the structure of the railway was reformed and brought under public control and largely under public ownership.

Although no independent rail regulator existed before privatisation, it is likely that the ORR would need to be retained, although probably with modified terms and powers. Its role would include overseeing access arrangements to UK railways for private operators where EU rules insist upon it: that is, for freight services and international passenger services through the channel tunnel. It might be responsible for ensuring a fair price was paid for the lease of existing rolling stock from the ROSCOs; and might also oversee the setting of track access charges for different freight flows and their fair application to freight operators in the private and public sectors.

12. The political programme for railway reform: now and from 2015

The following recommendations split into two categories:

- Practical steps that can be taken immediately
- An overall policy framework that the Labour Party could adopt in relation to rail reform, in preparation for action as a future Government.

12.1 Immediate practical steps for rail reform

For **passenger operations,** the Labour Party could:

- Promise that money saved from putting the railways back together will translate into lower fares in real terms for passengers.
- State that no new franchises will be signed under a Labour Government, and that as franchises expire, passenger operations will be brought together under public control.
- State that any franchising negotiations for Great Western, Essex Thameside, Thameslink, InterCity East Coast, South Eastern, Greater Anglia or Northern / Transpennine[175] that were still ongoing at the time of a change of government would be halted.
- State that an incoming Labour Government will review all franchises to assess whether, assessed over the life-time of a parliament, tax payers and fare payers would receive better value for money by immediate buy-out of certain franchises.
- Indicate that an incoming Labour Government will act with determination to reduce dividend leakage from train operators, including a 50% tax on all dividends paid by TOCs.
- Say now that there should be break points in all longer franchises let under the current Government, to allow for review including termination.
- Campaign through the European Parliament against the European Commission's stated intent to force member states to open their domestic passenger services to competition.

For **rolling stock**, the Labour Party could:

- State that it will regulate the ROSCOs' oligopoly to prevent profiteering, with 'fair price' regulation involving an independent expert.
- State that it will act to prevent dividend leakage from ROSCOs by instituting a 50% tax on dividends paid by ROSCOs.
- State that it will institute a planned programme of regularised investment in new publicly-owned rolling stock that would help to rebuild domestic train manufacturing capacity.
- Campaign through the European Parliament for the ongoing revision of the Procurement Directive to allow more flexibility to support domestic industry and jobs.

For **freight**, the Labour Party could:

- Show a determination to ensure against wastage of public financial support for freight, whether through dividend extraction or monopolistic practices, by indicating an intention to utilise publicly-owned DRS as a keen and efficient competitor within a future GB Rail.

For **governance** of the railway the Labour Party could:

- Say it will realise immediate savings of £156 million per year by bringing Network Rail's debt onto the public balance sheet, with further savings of at least £200 million per year by progressively bringing renewals and enhancements in-house.
- Promise to involve passengers and the workforce in creating a better railway by providing them with a formal governance role in an overarching rail body.
- Promise to give a greater role to the regions, Greater London Authority, Scottish Parliament and Welsh Assembly Government in improving local train services, within the context of an integrated national network.
- State that it will strive for more investment, lower fares and better services, as in the most successful European countries.

12.2 Policy for rail reform

The actions above should be in the context of an overarching Labour Party strategy to Rebuild Rail. At this stage, this should have the following key policy elements:

- The UK railway system should be as integrated as possible within the constraints of EU law. EU rules will be interpreted in the national interest, and not in a way that harms passengers and taxpayers by impeding the rebuilding of a unified railway within the public sector.
- The present fragmentation of the UK railway system and its attendant costs will be progressively reduced, taking advantage of all economical options to achieve this end.
- The UK railway system should be a railway for all, not an expensive service for a social elite. Over time, fares will be brought more into line with those in Europe.
- Public money being paid to the railways to fulfil social, economic and environmental objectives, whether as subsidies or fares, should not leak out as private profits and dividends. Leakage will be eliminated as far as possible within EU law by seeking, without excessive cost to the public purse, to regain public ownership of parts of the railway where such losses are occurring.
- The UK railway's potential to contribute to Britain's long-term prosperity and to an effective industrial strategy will be developed to the full, through support for regional rail services; investment in the freight network; and rebuilding domestic train manufacturing capacity.

Political steps need to be taken now to set Britain on the path to a reunified railway that offers the public a service they can be proud of. All of these political steps can and should be made openly and in public.

Now is the moment to set the signals at warning for the train operating and rolling stock companies. Such signals should be clearly given and mandated through electoral support so that commercial interests are forewarned.

The evidence of the last 17 years is that a privatised railway is too expensive, too bureaucratic, and too unresponsive to passengers and local people. Labour can do better. The arguments are clear and common sense and can command broad public support. It is time to lay it on the line.

13. Appendix: Key articles of the draft 'Recast Directive'

This Directive will recast the 'first railway package', which established EU-wide regulations of railways. The articles below are from the draft approved by the European Council of Ministers meeting of 12th December 2011 (EU Commission 2011) which is awaiting second reading by the EU Parliament[176, 177]. [Bracketed notes are our explanatory additions.]

Article 6

Separation of accounts

1. Member States shall ensure that separate profit and loss accounts and balance sheets are kept and published, on the one hand, for business relating to the provision of transport services by railway undertakings [this term is used to mean train operators] and, on the other, for business relating to the management of railway infrastructure.

Public funds paid to one of these two areas of activity shall not be transferred to the other.

[The definitions section of the recast directive states that: 'infrastructure manager' means any body or firm responsible in particular for establishing, managing and maintaining railway infrastructure, including traffic management and control-command and signalling, and that the functions of the infrastructure manager may be allocated to different bodies or firms]

[Paragraphs 2 & 3 deal with different matters: paragraph 2 allows Member States to specify a particular legal structure to guarantee the accounting separation, and paragraph 3 specifies separate accounting for freight and passenger services]

4. The accounts for the different areas of activity referred to in paragraphs 1 and 3 shall be kept in a way that allows monitoring of the prohibition on transferring public funds paid to one area of activity to another.

Article 7

Independence of essential functions of an infrastructure manager

1. Member States shall ensure that the essential functions determining equitable and nondiscriminatory access to infrastructure, are entrusted to bodies or firms that do not themselves provide any rail transport services. Regardless of organisational structures, this objective must be shown to have been achieved.

The essential functions shall be:

– decision making on train path allocation, including both the definition and the assessment of availability and the allocation of individual train paths, and

– decision making on infrastructure charging, including determination and collection of the charges, without prejudice to Article 29(1) [this Article covers Member States' duties and powers to set an access charging framework].

Member States may, however, assign to railway undertakings or any other body the responsibility for contributing to the development of the railway infrastructure, for example through investment, maintenance and funding.

2. Where the infrastructure manager, in its legal form, organisation or decision-making functions, is not independent of any railway undertaking, the functions described in Sections 2 and 3 of Chapter IV [these sections specify duties to set up access charge structures according to certain principles, and even-handed procedures to set up agreements with train operators allocating infrastructure capacity] shall be performed respectively by a charging body and by an allocation body that are independent in their legal form, organisation and decision-making from any railway undertaking.

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[13] Just Economics (2011) *ibid.* Annual figure is for 2009; cumulative figure is for 1997-2009

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