FT Series **Privatisation revisited**

The Big Read **UK privatisation**

Rail: frustration grows with Britain's fragmented network

Privatisation was meant to deliver competition, innovation and improved service, but has it delivered?

Gill Plimmer and Jonathan Ford in London
4 HOURS AGO

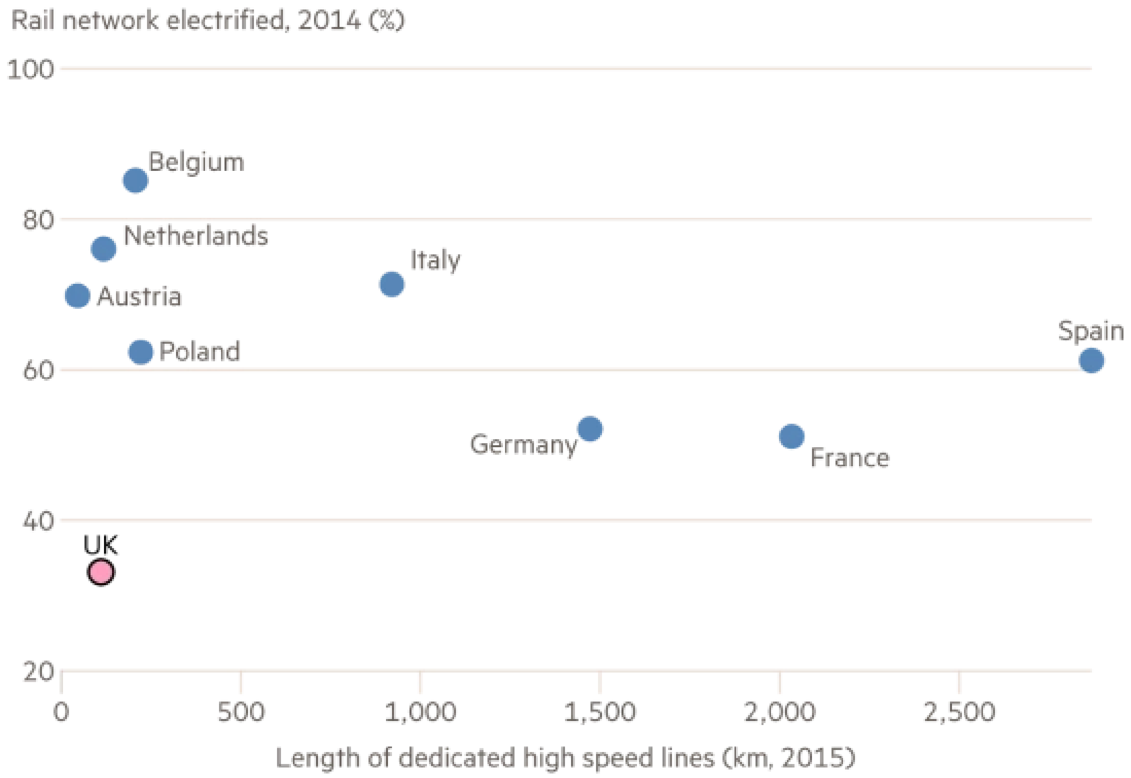
Craig Johnstone checked tickets and train doors for more than 30 years. But if the job did not change, the uniform did: five times he donned new colours bearing fresh slogans as a different company took over running the Leeds to Manchester and Carlisle service.

"Every uniform gets a little tighter — and I can't fit into the old ones," he says. "They change the roles and description and then they change them back again. That's all the rail operating companies do. It's continuous change, but all that changes are the colours and the corporate brands."

Change was supposed to mean more than just a new cap and blazer when John Major's Conservative government released its plan to split up British Rail in 1992. Then UK ministers outlined a vision of private companies bidding for franchises and bringing fresh ideas, dynamic management and innovation.

"More competition, greater efficiency and a wider choice of services more closely tailored to what customers want," proclaimed the 21-page white paper that drove forward a privatisation that had been too controversial even for Margaret Thatcher, his predecessor, to risk.

The UK's rail infrastructure still lags behind European networks



Source: EU Commission 2016 Rail Monitoring Report
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Two decades on, passenger numbers have more than doubled since the last year under British Rail. The UK network saw 1.7bn passenger journeys in 2016-17, against 735m in 1994-95. After decades of decline, Britain’s trains are busier than at any time since the first world war.

But behind the numbers lies a conundrum: how much of this is due to the benefits of privatisation, rather than demographic factors such as the shift to the suburbs, increasing urban congestion and a rising population?

Privatisation has certainly led to more train services. According to an EU study in 2013, the UK’s trains and tracks are now more intensively used than any other developed European market bar the Netherlands, and this has undoubtedly contributed to the growth in passengers.

Investment is up too; it is running at around four times the £1.6bn a year it averaged in the late 1980s, with £925m coming from the private sector last year, mainly to fund new rolling stock.

“Privatisation reduced the malign influence of HM Treasury which wouldn’t allow a proper investment programme,” says Lord Freud, a former banker who advised on rail privatisation.

But it is not obvious that two decades of private ownership have led to similar advances in service quality or have made the network more financially sustainable and secure.

“It’s very hard for people to travel around and not suffer from the cracks in the system,” says Christian Wolmar, a train historian. “It’s everything, from knowing who to buy a ticket from to the signalling failure that delays the train to the lack of information when your train is cancelled. It's hard to know which is worse — fragmentation or privatisation — but I'd probably say fragmentation."

The track: Network Rail

© Bloomberg

The listed company Railtrack collapsed in 2001. The UK's infrastructure has since been back in public hands under the control of Network Rail

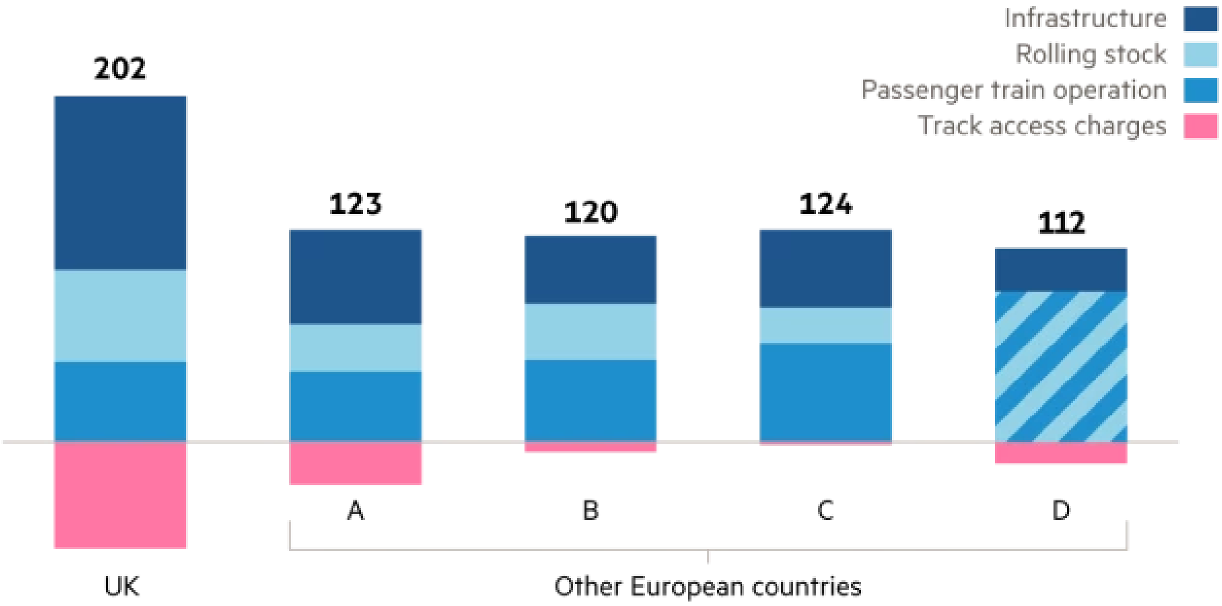
The break-up of the network is perhaps the most hotly debated legacy of the sell-off. Instead of pushing British Rail into the private sector as a single regulated monopoly akin to water or electricity, the government chose to break it into three components of track, rolling stock and train operators, and then to sell it in no less than 100 pieces between 1995 and 1997.

This process has not made the network cheaper to operate. The cost of running the UK's railways is 40 per cent higher than it is in the rest of Europe, according to a 2011 government report by Sir Roy McNulty, the former boss of UK aviation group Short Brothers who has long experience in transport regulation.

"The train you catch is owned by a bank, leased to a private company, which has a franchise from the Department for Transport to run it on this track owned by Network Rail, all regulated by another office, and all paid for by taxpayers or passengers," says John Stittle, a professor of accounting at Essex university. "The complexity is expensive."

Units costs of UK rail are 40% higher than in Europe

Whole system costs (£ per thousand passenger kilometres, 2011, partly normalised*)



* Infrastructure has been fully normalised, train operation and rolling stock have been normalised for countries where normalisation factors were known. The total figures shown do not include the track access charges
Source: Civity
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Since privatisation, the bill has mainly been shared between the taxpayer and the passenger. The contribution from the state has almost doubled from £2.3bn in 1996 to £4.2bn in real terms in 2016-17, despite a conscious decision in recent years to push more of the cost on to users’ shoulders. Ticket prices have risen: they are now 25 per cent higher in real terms than in 1995 and 30 per cent higher than in France, Holland, Sweden and Switzerland. The latest average rise in fares of 3.4 per cent, announced on New Year’s Day, was greeted with outrage.

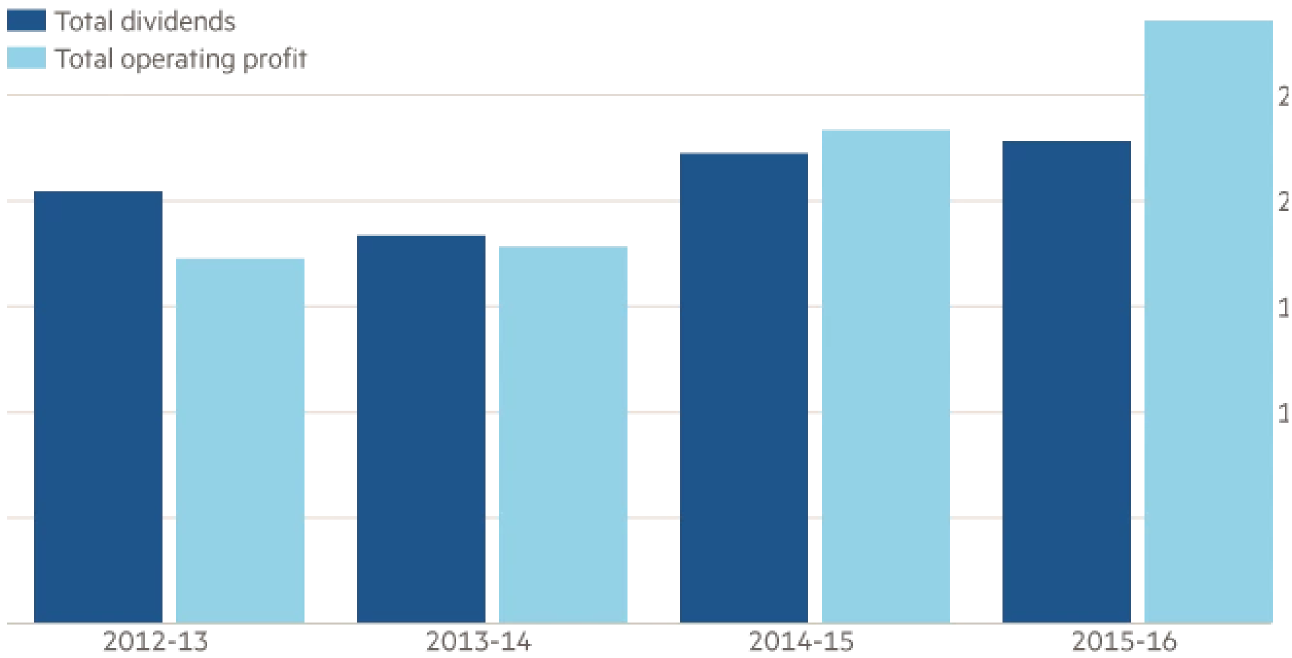
Privatisation was supposed to unleash efficiencies that would justify the returns private operators demand for their services. So why, more than two decades in, have the UK’s railways not delivered more?

Despite the vastly expanded usage, the network’s costs have not obviously come down relative to its income. According to the 2011 report, unit costs per passenger kilometre were roughly 20p in 2010, much the same as they were in 1996.

One reason, suggest the critics, is that privatisation never really took root. The network’s 2,500 stations and 32,000km of tracks were initially vested in a listed company, Railtrack, which later collapsed. Since 2001, the infrastructure has been back in public hands under the guise of Network Rail.

Profits barely exceed dividends in the UK rail industry

UK train operating companies (£m)



Source: ORR
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Fragmentation, meanwhile, has encouraged each part of the system to prioritise its own profits rather than collaborating to improve the system. “It’s an adversarial relationship with Network Rail,” says one director of a rail franchise. “We call them blame departments. People who sit around at Network Rail and the train companies deciding whose fault it is.”

Indeed, the subsidies in effect insulate the operators from those extra expenses the network incurs. While it cost £4.1bn to provide maintenance and renewals work on the system in 2016-17, the train operators paid £1.5bn to access the nation’s tracks. This is half of what they paid at privatisation, even though those tracks are now far more heavily used.

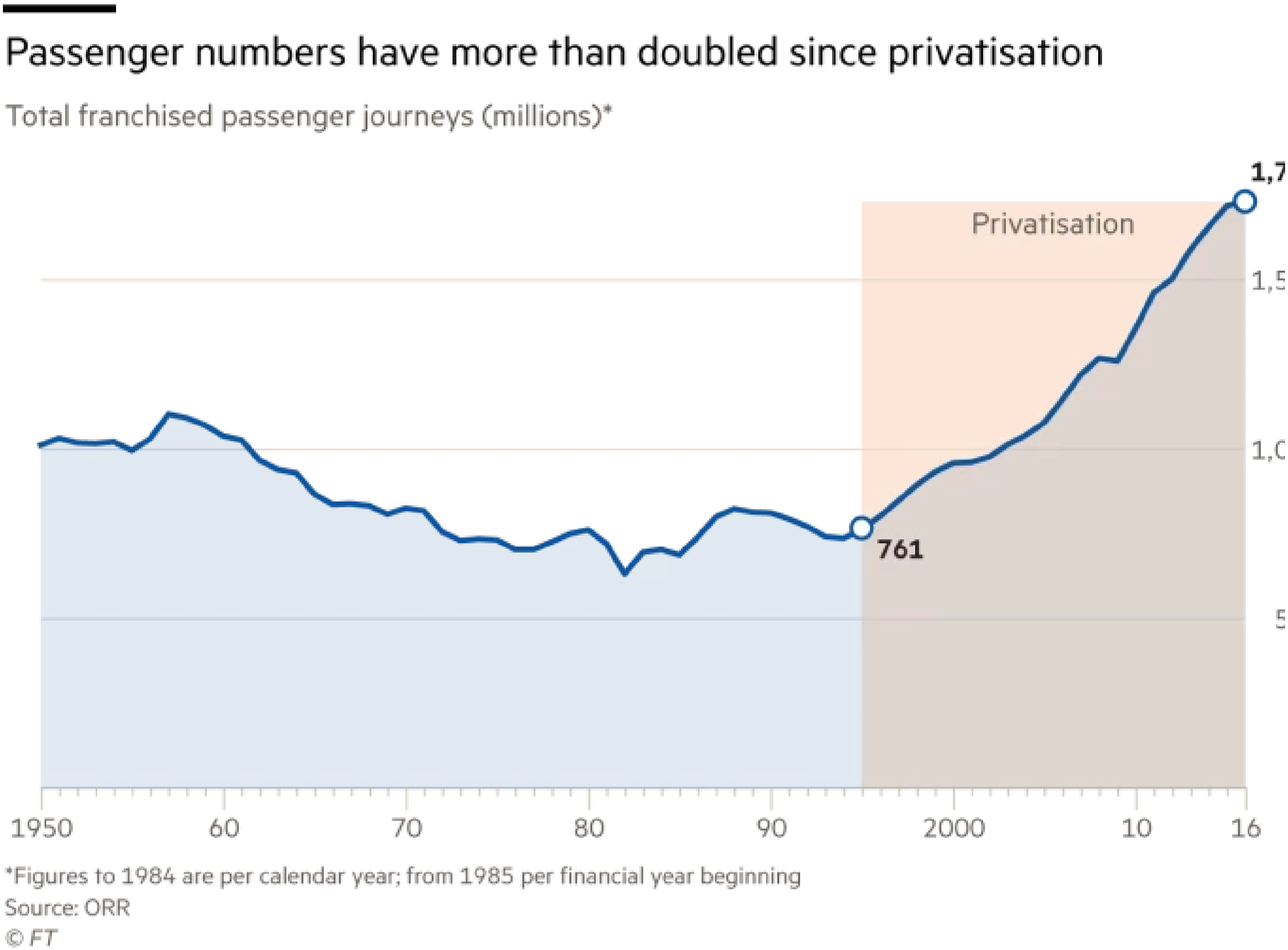
The rolling stock (led by Angel Trains, Porterbrook and Eversholt)

In 2009 the Competition Commission said the owners of the trains could have cost the taxpayer as much as £100m a year by overcharging operators

Of the parts of the sector that remain in private hands, it is the train operators that are now the subject of fiercest contention. Although the data on quality are mixed, with the UK performing better than some European countries in terms of punctuality and reliability, there is a perception that service is poor despite all the public subsidies.

Journeys are often uncomfortable: 23 per cent of customers commuting into London at peak hours have to stand. According to the consumer group Which?, delays of at least 30 minutes afflicted more than 7m journeys last year.

Critics argue that train operators are able to make returns, and pay themselves dividends, despite contributing very little in the way of risk capital. While operating margins of 3 per cent are not high, the operators have paid dividends of £654m between 2012-13 and 2015-16, compared with total operating profits of £868m.



The train operators have few tangible assets and almost no exposure to business risk. Indeed, their franchise agreements frequently offer revenue protection should there be an economic decline or changes in London employment levels — the two biggest drivers of passenger numbers.

What the private owners mainly deliver is marketing nous; promoting services and experimenting with timetables and branding. While more than a third of ticket prices are set by the government, they have freedom to set the remainder at levels they believe the market will bear.

So deep is the dissatisfaction that one group of long-suffering customers who will pay up to £4,696 this year for a season ticket on the poorly performing Southern service between London and Brighton, just an hour away, created a musical dubbed "Southern Fail". Following a series of strikes, the satirical website The Daily Mash said Southern had decided to "replace the timetable with an avant-garde poem".

As with other privatised monopolies, competition was supposed to ensure lower prices and sharper services. But in recent years this has faded, raising questions over the legitimacy of the franchising system. A third of train operating companies now hold their franchises by so-called "direct awards" from government, rather than auction.

The train operators

© AP

Train operating companies, which lease rolling stock, point to their modest operating margins of 3% and limited franchises as impediments to investment

Successive governments, out of an apparent desire to keep the private sector onside, have been reluctant to wield their powers against poorly performing franchises. Only one train operator has ever been stripped of its contract — Connex for poor performance in south-east England in 2001 and 2003. Three more have walked away after overbidding for contracts, with minimum penalties.

Last month, the government allowed Virgin Rail and Stagecoach to terminate their East Coast line franchise three years early, saving them the need to write a £2bn cheque to the government under previously agreed revenue growth forecasts. Yet with only a handful of operators bidding for franchises, the duo may end up operating the line again — on more profitable terms.

Lord Adonis, a Labour peer who recently resigned from the National Infrastructure Commission, called the "bailout" a "scandal" that "threatens to undermine the legitimacy of the whole franchising system". He argues that the government should keep a state-owned operating company in reserve, to demonstrate to franchisees that it can reassume their obligations if they fail.

When National Express handed back the keys to the East Coast line franchise in 2009, it was renationalised under an arm's-length government body called Directly Operated Railways. Nevertheless, during the following five years under state control, it increased ticket sales, returned about £1bn to the taxpayer and delivered record levels of customer satisfaction.

In numbers

£4.1bn

Cost of critical maintenance and renewals of the rail network in 2016-17. Rail operators paid £1.5bn to access the track in the same period

25%

Percentage in real terms by which UK rail ticket prices are higher now than in 1995

21 years

The average age of the rolling stock on the network, which has doubled since 2008

The rolling stock — which is leased to the train operators for about £1.5bn a year — is still largely owned by three companies: Angel Trains, Porterbrook and Eversholt. Each is in the hands of financial investors, each with convoluted multi-tiered, overseas ownership structures, sometimes making tracing the flow of money difficult. Eversholt is owned by a Hong Kong company with a Cayman Islands subsidiary; Angel mostly by Luxembourg-based investors; and Porterbrook by another consortium of international investors.

Lord Andrew Adonis on a train near Norwich when he was a Labour secretary of state for transport © Si Barber

The Competition Commission concluded in 2009 that the rolling stock companies could have cost the taxpayer as much as £100m a year by overcharging operators on leasing rates. More recently, the government has attempted to procure some new trains directly using complex private finance initiative deals — which cuts the rolling stock companies out of the process — although that too has been criticised as poor value for money by public spending watchdogs.

The government's micromanagement of procurement has also slowed the pace of ordering, meaning the average age of rolling stock has almost doubled since 2008 to 21 years — roughly the same age as pre-privatisation.

There is a growing consensus among both executives and industry experts as well as the public that Britain's unique attempt to create competition on Britain's rail network has not delivered.

While it has led to more services, and encouraged more users to pay higher prices, it has not unleashed the productivity improvement necessary both to upgrade the network and stabilise the network's finances.

Over the same period, for instance, London's state-owned metro network, Transport for London, has grown just as quickly and delivered much more state-of-the-art investment.

Prime minister John Major presided over the privatisation of the railways, which split British Rail into three © FT

This has brought forward calls for more chopping and changing. To deal with the problems of co-ordination and planning, Chris Grayling, the transport secretary and an advocate of private sector involvement, is pressing for formal joint ventures between private franchises and Network Rail on some routes, so that eventually operators can take more responsibility for the tracks.

Another option — advocated by some franchise holders — is to ape the way Transport for London commissions services from the private sector, taking the revenues and responsibility for service delivery, while contracting out bus and train provision on tightly specified terms.

Some argue there is a simple solution: reunite track and train in the only feasible manner, a return to public ownership.

Jeremy Corbyn, the opposition Labour leader, has proposed putting the franchises back under state control as they expire and commissioning trains directly from manufacturers. An October poll by the conservative think-tank Legatum found nearly three-quarters of the UK population agreed with him.

Labour's critics, however, say that its plans would do little to solve the well-known failings of Network Rail. "The thing that makes me laugh is how people have forgotten how they used to hate BR," says Lord Freud. "It was a national laughing stock."

As for Lord Adonis, he argues that further revolutionary change is pointless and "no simple ownership change can fix the railways".

But back in Carlisle, Mr Johnstone, who now works for the Northern franchise currently run by Deutsche Bahn-owned Arriva, supports a return to state control. "If you scrape the paint off, eventually you get to British Rail. But before you get to British Rail you get to the last time Arriva had the franchise about three coats in," he adds. "If you keep painting them they won't make it through the tunnels — there's that many layers of paint on them."