2. BRITISH RAIL FRANCHISING: AN EXPERIENCE IN CHOPPY SEAS

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SUMMARY

The Regulatory and Political Framework

My 5 year-term as the Rail Regulator in Great Britain from 1999 to 2004 coincided with the most turbulent times the British railway industry has ever experienced in peacetime. It was a great honour and privilege to do that job, yielding as it did valuable lessons for rail regulation in the most testing of circumstances.

The jurisdiction of the British Rail Regulator is probably the greatest of all the regulatory authorities in Europe, and perhaps anywhere in the world. It should be borne in mind that the Rail Regulator, which was independent of government, did not carry out passenger rail franchising. Franchising was carried out by a politically controlled agency of central government. As Chris Nash and Andrew Smith's paper describes, this agency – called the Strategic Rail Authority – has since been abolished and the functions taken back to the Ministry of Transport. I agree with Chris Nash's observation that, with this development, today we have the highest degree of control that the Ministry of Transport in Britain has ever had over the railway; we will see whether they can make a success of it.

The Rail Regulator is independent of government. The single person rail regulator model – where all the power is vested in the hands of a single individual office-holder – was abolished immediately after I left office in July 2004. This change was in line with reforms to the regulatory model for all the UK economic regulators; rail was the last industry-specific regulatory authority to undergo this change. The single person regulatory model has been replaced with a seven member board. The main motive was to change the dynamics of decision making, and this has indeed happened, in ways beneficial to politicians which perhaps they could not have foreseen.

With this background, the themes that I will deal with are as follows:

- The expectations of franchising of passenger services in 1994.
- High degrees of prescription in original contracts.
- Faults in the foundations of the franchising system.
- Degrees of political intolerance which the industry has had to endure.
- The need for realism.

First though, a "health warning": I do not advocate that any country copies the British system. Instead my position is that it would be wise to take the benefit of the lessons that have been learned in Britain through the very tough experience of the last 13 years in the design of franchising and regulation, the implementation of railway re-organisation, and in the radical reform of the institutional and matrix structure that we were compelled to carry out in the years 1999-2004. We have now got it right but we went through the fires of hell to get there.

Performance of the Railway since Privatisation

The privatisation of British Rail is not an unmitigated disaster or an institutional shambles despite the very different agendas of different political forces at work. Ministers, quasi-ministers and other politically motivated agencies sought, on occasion, to direct the railways as if they were still a state owned monolith. We had to deal with the media who love trouble on the railways, especially severe and open disagreements on policy, and major rail accidents. For example, after the Paddington railway crash in 1999, when 31 people died and many more were injured, a senior policeman told me at the scene that in 25 years of police experience, he had never come across more discreditable behaviour by the British media when all they wanted to know at the daily press conferences was when the death toll would reach 100. They were very disappointed when it didn't.

We have had major successes in the growth of passenger and freight traffic on the railways, significant rolling stock replacement, huge investment in infrastructure, some of the best measures of track quality that we have ever had, and generally putting right the accumulated policies and problems of the years of nationalization. Our model has been, to paraphrase Captain Kirk in Star Trek: "free enterprise, but not as we know it, Jim"!

Some statistics: in passenger-kilometres, traffic grew between 1994-1995 and 2004-2005 by 46.4%, from 28.7 million to 42.4 million, and we forecast further growth over the next 10 years of 28%. In train-kilometres, traffic grew between 1997-1998 and 2004-2005 from 376 million to 456 million, an increase of 21%. Since privatization a fleet of 4 500 railway vehicles has been replaced with an investment of 7.8 billion euros. We now have amongst the world's biggest train fleet modernization and replacement program and one of the youngest passenger rolling stock fleets in Europe, with an average age of 14 years in 2005. In terms of passenger satisfaction, between 2001 and 2005 the index we use for measuring satisfaction rose from 73% to 82% for long distance services, for London & the Southeast it rose from 66% to 73%, and on regional railways it improved from 77% to 83%. This does not suggest that people are deserting the railways because they are a disaster; these are people who want to travel on the railways because they are a success, meeting the needs of users at a fair and affordable price.

Prerequisites for Reform

When governments decide to restructure, reorganize, corporatise, regulate, de-regulate competitively tender or franchise their railways – there are many approaches and the terminology is wide – they have to do some things that we did not do in Great Britain in 1994. They need to be clear about what they want to achieve. They need to be honest about what can be achieved.

Governments should grant the necessary resources to do the job properly, in time, expertise and money. They should establish sound and sustainable relationships in this new matrix which they create, whatever model they choose. If there is vertical separation between the infrastructure provider and the train operator, that structural decision should be respected, not assaulted. If there is a separation of responsibilities between government agencies that are politically controlled and any that are supposed to operate independently, that too should be respected and made to work. Government should respect and facilitate the roles of the public and private sector organisations. They should respect and sustain the matrix which has been established. None of these thing happened in Great Britain, and the results were both severe and adverse. On the positive side, I can say that we have now reversed these adverse effects and put right the shortcomings of the original design and implementation decisions.

Evolution of Reform in Great Britain

At the beginning of franchising in Great Britain in 1994, here were several expectations and assumptions: the railway would decline; there would be no appreciable new capacity apart from the channel tunnel rail link; we would have a competent and efficient network provider Railtrack; we would have empowered, efficient and competent passenger train operators; and we would have a declining need for public subsidy. Some of the franchise bids were ludicrously ambitious, but the infrastructure manager (Railtrack) had no proper appreciation of the condition, capacity or capability of its network assets, the track and signalling system on which so much depended. We were assuming that on-rail competition would thrive. We have had one open access passenger train operator (Hull Trains) and we have one more open access passenger train operator (Grand Central Railway) that is struggling to get on to the network ten years after the policy was devised. That is mainly because the government is trying to kill open access. The politicians will not let go.

We have had two governments in the period of privatization with completely different philosophies. The Conservative government of 1992 to 1997 was elected against everyone's expectations (including their own). They decided to restructure the railway and privatise it at breakneck speed. In 1993-95, I was seconded to the first Rail Regulator as his chief legal adviser. In that period, I saw corners being cut, shortcuts being taken, weaknesses built into the system – some of them deliberately, some of them negligently, some simply because there was no time to design a proper system. The Government was absolutely determined to sell the whole industry in five years, and they succeeded. But what they did not do – as politicians are politicians – was think of what would happen afterwards. Some of us seeing the difficulties that were being established for the system, built mechanisms for change into the system, so that after privatization, after the private sector had been brought in, the matrix of financial, contractual and public accountability could be altered without the need for unanimous agreement of the parties concerned. Because I was working for the regulator at the time, I drafted most of these powers for change. I put the change powers in the hands of the regulator. I did not in any way expect to be the regulator who would come to use them in later years. In the event, I used all of them.

The Labour government was elected in 1997 and is still in power. The Labour Party opposed rail privatization. It lacked the will to reverse privatization when it took office (although when it took Railtrack into administration it claimed that it had reversed the privatisation of that company).

In much of what it does, the present Labour government has taken to itself a high degree of specification and control over the railway, so much so that it is sometimes said they want to snuff out any power or freedom of commercial development on the part of train operators. They also failed to work with the established matrix of contracts and licences, the financial regime and the economic architecture of the system. Many members of the Government failed to understand how the system had been improved and strengthened by the reform programme that had reversed the mistakes of privatization in these respects. Instead they blundered into interference which almost always did harm.

The Essentials for Success

In establishing a restructured railway industry, there are several essential measures of success – you need a sound and sustainable framework of regulatory, economic and legal rights and obligations to create:

- Stability.
- Predictability.
- Sound incentives.
- Sound, clear and sustainable risk allocation.
- Protections from the abuse of monopoly power and unwarranted political intervention.
- Fair processes and fair treatment.
- Clarity of responsibilities.

That is the shopping list for any country anywhere in the world which is contemplating reorganizing any industry. Railways are complex. Trains are not like electrons – passengers care where they get on and off the system and how the journey was. Electrons don't vote; people do. Railways are very much more complex than energy or telecommunications or water systems, but they are still networks This is a shopping list of essential requirements for all network industries. In the case of the British railway industry, these essential requirements were neither properly understood at the time of privatisation nor fully achieved until much later, after major reforms had been retrofitted to the system.

The major flaws were in the key financial regime – the access charges regime. During my time in office, I carried out two major reforms of the economic architecture of the financial regime: in October 2000, just days before the Hatfield accident, and in December 2003. I increased the money available for the operation, maintenance and renewal of the network by Railtrack and then Network Rail – an increase of 33.4 billion euros over five years. (This did not make me any friends in political circles, and it was explained to me rather discreetly what would happen to me if I did make these decisions. I made the decisions, and the things that were explained to me did happen; government kept its promise that time!) These financial increases were not because of privatization. Privatization exposed the failures, the shortcomings, the neglect of the years of nationalization and the six years of neglect of the Railtrack stewardship of the network. It did not cause these increases; these increases would have happened anyway.

In these financial reforms, we also moved from enforcement regulation to incentive regulation, and completely revised the performance regime. Let us remember that in Directive 2001/14/EC there is a mandatory obligation to have a performance regime – it is not an optional extra.

The privatisation licensing regime was unduly weak. And so I retro-fitted it into the infrastructure manager's network license nine new conditions. I will just mention one: an asset register – how about knowing what the condition is of the network assets, would that not be a good idea? My fellow economic regulators in energy, water and telecommunications could not believe that we had to put into the license of the network provider a requirement to have such a register. If you are in asset-intensive industries like these, the first thing that you do is figure out the condition and the performance of your assets, but regrettably Railtrack did not do that.

The track-train interface was significantly flawed. We have now reformed the system into a true joint venture with an intensity of interdependence between track and train which is recognised, facilitated and supported. That reform has been particularly successful since it was made.

We rewrote the contractual matrix with new model access contracts for passenger and freight train operators. We reformed the industry-wide network code – the common rules for operating on the network – in significant respects. And I predict that in ten years time we will have a single network code for the single European railway area.

The Franchises

Passenger rail franchising is another area in which the politicians just simply can not let go. The new generation of franchises – introduced in the period 2004-2006 – are amongst the most restrictive contracts imaginable. I did not have anything to do with designing them, I just objected to what was being done. The new model franchise stifles the most innovative flair that the train operators might have had. There is a great debate about how much scope for innovation that there might be, and Peter Kain takes up this story in his paper, but the franchisees would have some scope for innovation if the life had not been squeezed out of them. British passenger rail franchises are now little more than complex management contracts, and I think that is a big mistake. It is not necessary to tell the private sector operator in 400 pages that he needs government approval as to whether he is to breathe in, and that he may or may not get consent to breathe out. It is just too constrained.

Effects

The results of the flaws identified above, coupled with the paralyzing incompetence of Railtrack – with its very poor asset knowledge, fundamentally flawed asset management and maintenance policies and practices, and their attitude that running on their network was a privilege for the train operators and not a right – led to disaster. Railtrack neglected its core assets and concentrated on big projects, and did all of them badly. They had a visceral hostility toward their customers. The train operators were further down the food chain, they had contracts which were uncertain, they were un–empowered and unprotected by a weak regulatory regime pre-1999. Then there was the Hatfield crash in October 2000: a broken rail, 4 people killed, 76 injured. The aftermath of Hatfield saw very severe disruption, a 92% fall in performance and 215% increase in costs over the next year, with huge financial pain for the passenger and freight train operators. That is why most of the passenger train operators were put on cost-plus management contracts. Although it is a complex story, most franchises converted to cost-plus contracts for a time because the remedies available to them under those contracts with Railtrack simply were not calibrated to deal with disruption on that scale.

The explosion in costs and the severe fall in performance have since been reversed. The government bail-outs were mainly a result of the severity of the network problem, the lack of empowerment and the flaws in the design of the track-train interface. We also had a fire storm of political pressure, unwarranted intervention from a number of sources including ministers, and a year later Railtrack was forced into a special class of insolvency in the most controversial circumstances possible. The key weakness was the design of the interface between train and the track.

Conclusions

In conclusion, franchising in Great Britain has been a success, but not an unalloyed success. We have had severe problems, but we have been successful in franchising, with the growth in passenger kilometres, in train miles, in rolling stock improvements and many other respects *despite* the major shocks and the major flaws in the design of the system. Who knows what we could have achieved if the design decisions in 1994, 1995, 1996 had been better?

Government must take its share of responsibility for all this. It is government that is principally responsible for the major increases in costs, not just because they forced Railtrack into administration – although they simply could not come to terms with the fact that that was the direct cause of some of the most severe financial consequences – but because of the years of neglect of the national network. The state corporation British Rail did very well in the days of nationalisation in making-do and mending a system which had significant underinvestment for a long, long time. I was full of admiration at just how good a railway these people could run with so little money. With privatization, and the decisions I took in October 2000 to increase the access charges, and therefore the income for the network, by 50% and then to increase them by 50% again in 2003, we recognised it was necessary to correct for those years of neglect. It was severely painful for the government to have to find so much money to fix the railways, but it must be recognised that it was government decisions over the years which had allowed the railways to deteriorate so far.

The matrix reforms that I mentioned – financial, contractual and public accountability – were not initiated by politicians. I struggled to get the politicians even to understand them, let alone to embrace them, and they never supported them. Interestingly, if you read last year's government White Paper on railways, published 10 days after I left office, you will see all of my reforms promoted by Ministers as their ideas! That is very flattering and recalls a favourite saying of US President Ronald Reagan (it wasn't his): "There is nothing a man cannot achieve in his life, if the does not mind who takes the credit".

The politicians, however, will not leave the system alone. They have fiddled and legislated, and they will fiddle and legislate in perpetuity. It is said in Great Britain that every piece of railway legislation ensures the next one. I believe that to be true. When I left office I was asked what I expected to being doing in 10 years time. I said that I expect to be reading the latest government White Paper on the reform of the railways.

We have seen major improvements in track quality, in efficiency, in cost control, in performance, in the interface design and in virtual integration of our railway. I repeat that these things have been brought about despite and not because of direct government action. Our British railway industry has gone from storm clouds to a bright new dawn. It is not perfect, but it is a great deal better than you will read in the pessimistic and often ill-informed assessment of some of the industry's critics. Britain now has a reorganised railway system – institutional, contractual, legal, economic and operational – worth learning from. Having proper regard to Britain's experience since 1994, other countries are better able to achieve their own railway reform objectives with considerably less pain that ours.

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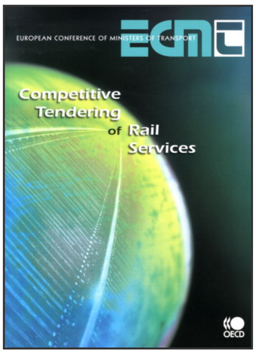
ABBREVIATIONS

AFI	Annual Financial Improvement
BOT	Build, Own and Transfer
BR	British Rail
CEO	Chief Executive Officer
CER	Community of European Railway and Infrastructure Companies
CN	Canadian National Railway Company
CPTA	County Public Transport Authorities
CUP	Capacity Utilisation Policy
DB AG	Deutsche Bahn AG (German Railways)
DfT	Department for Transports
DOI	Department of Infrastructure
DSB	Danish State Railways
EWS	English Welsh and Scottish Railway (freight operating company)
GDP	Gross Domestic Product
GNER	Great North Eastern Railway
GOVIA	Partnership of Go-Ahead and Keolis (train operator)
ITC	Independent Television Commission
MBO	Management Buy Out
MTL	Rail subsidiary of MTL Holding (operator of Merseyrail services)
NAO	National Audit Office
NEG	National Express Group
NERA	National Economic Research Associates
NPV	Net Present Value
NR	Network Rail
NS	Dutch National Carrier
OPRAF	Office of Passenger Rail Franchising
PSR	Passenger Service Requirement
PTC	Public Transport Commission
PTE	Passenger Transport Executive
RBI	Rail Business Intelligence
ROSCO	Rolling Stock Leasing Companies
RRPS	Regional Rail Passenger Services
SJ	Swedish State Railways
SRA	Strategic Rail Authority
TOC	Train Operating Company
WAGN	West Anglia Great Northern



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