UK railway privatisation

Where did it all go so wrong?

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Executive summary

- UK railway privatisation was undertaken in the mid-1990s, but it has now hit the buffers following the Department of Transport's decision to replace the controversial railway franchising system – the core element of the privatisation policy – with Emergency Recovery Measure Agreements (ERMAs): these are essentially stop-gap arrangements.

- In reviewing 25 years of UK railway privatisation, the successes need to be laid out. However, the "where did it all go so wrong" question, famously asked of the legendary footballer, George Best, also has to be addressed.

- Between 1995, shortly before the first train covered by the franchise arrangements – the 5.10am on 4 February 1996 – left Twickenham station, and 2014, passenger journey numbers on the railway network more than doubled, from 735m to 1,660m. Despite some over-crowding problems, especially on commuter lines into London, this surge in demand was accommodated, albeit with periodic shortcomings.

- Investment levels remain high in the railway sector. Much of the capital expenditure has been undertaken by Network Rail, which – despite well-publicised electrification issues – still managed to invest £5.2bn in 2019/20 alone.

- Via the rolling stock companies (ROSCos), there has been modernisation of the rolling stock across the network, with the phasing out of many old self-powered diesel units. Stations, too, have been transformed, such as Birmingham New Street, and new stations, such as Bromsgrove, opened.

- The failures of railway privatisation are several. Its key privatised element was Railtrack, which was suddenly re-nationalised as Network Rail in 2001. The move to ERMAs is now the final nail in the coffin. Plus, it is not clear whether the various operators will wish to become glorified ticket-collectors – to ensure the fare-box is topped up – under the new system.

- The major flaw in the privatisation policy was the decision – apparently driven by the Treasury – to reject vertical integration: the Isle of Wight being an exception. Where competition is inevitably limited, vertical integration – with strong regulation – has worked well, as in the water sector. And the hopes of widespread open access arrangements never materialised – even 25 years on, they account for ca.1% of all passengers.

- Instead, the railway franchise system was thrust on the industry. It encouraged very aggressive revenue assumptions, especially on the East Coast Main Line (ECML) – a graveyard for successive Train Operating Companies (TOCs). Franchise periods varied greatly; too short a period would deter investment whilst too long a franchise might give rise to inefficiency by an incumbent.

- Accountability has also been a key issue, with Network Rail, rather than the TOC, being responsible for ca.60% of all train delays. Furthermore, increasing participation by publicly owned overseas railways, benefiting from very low interest rates, was hardly the original intention of the privatisation policy.

Background

Utility privatisations were very popular

Whilst the privatisation policy of the 1980s focused primarily on utilities, including British Telecom, British Gas, the 10 water companies and the electricity supply industry, the focus moved to the railway sector in the early 1990s.

Private sector drove UK railways until 1948

Originally, the UK railway network had been developed by private companies during the great construction era of Victorian Britain. By 1948, though, they had been nationalised as British Rail, an amorphous, bureaucratic organisation that attracted much criticism from passengers, whose requirements seem to have been accorded little priority.

The big split

In the mid-1990s, British Rail was controversially split up with the rail network being transferred to Railtrack while the customer-facing passenger transport element was subjected to a franchising system, whereby bidders would apply to become the TOC for a specified region. Freight was handled separately whilst the management of rolling stock was allocated to the three ROSCos.

Vertical integration ditched –wrongly

The railway franchising system was chosen, partly at the instigation of the Treasury in its quest to drive ahead competition, via open access, on the network. Hence, vertical integration, as a policy, was discarded, apart from on the Isle of Wight. Hence, the concept of a regional railway system, which had been the model pre-war, was not reintroduced – a major error.

TV auction precedent – and infamous Midlands bid?

Instead, the railway franchise system, which – arguably – had its roots in the controversial TV franchising auction in 1991, where the right to broadcast in the valuable Midlands region was won by the sole bid from Central Independent Television for a derisory sum, was adopted.

Historic 5.10am Twickenham train on 4/2/1996

The first franchise put out to tender was won by Stagecoach, which – despite its colourful history – had prospered on the back of the privatisation of the bus sector during the 1980s. On 4 February 1996, the 5.10am train to London Waterloo duly left Twickenham station, thereby becoming the first passenger train service to be operated under a private franchise since 1948, when the network had been nationalised.

Railtrack IPO – and its subsequent demise

Subsequently, in 1996, the IPO of Railtrack, the owner of the nationwide rail network and many related property assets, took place. Despite a massive backlog of maintenance, it prospered initially, before failing in 2001, when it was re-nationalised, virtually overnight.

COVID-19's impact

Over the past two decades, passenger numbers on the railway network had grown sharply until they were decimated by COVID-19 in 2020 – a scenario that continues to this day.

Money-go round franchise system

On the railway franchising front, there have been various controversies in a flawed – and financially complex – process. First, several offshoots of EU publicly owned railway companies have been successful with their bids – aided by access to cheap government-backed financing. Deutsche Bahn, SNCF/Keolis, Trenitalia and Abellio have all featured prominently as bids from UK quoted companies dried up.

WCML shambles

The long-running episode involving the re-franchising of the West Coast Main Line (WCML) highlighted some dreadful modelling errors at the Department of Transport – legal proceedings ensued.

The final nail – via a terse announcement

Not surprisingly, COVID-19's devastating impact on rail passenger numbers has proven to be the final nail in the coffin for the beleaguered railway franchising scheme, as the terse announcement from the Department of Transport on 21 September 2020 confirmed.

Arrival of yet another railway acronym – ERMA

Existing rail franchising contracts are to be replaced – with immediate effect – by new Emergency Recovery Measure Agreements (ERMAs). In time, a White Paper will be published, with a range of proposals to reform the UK railway system – how it should be managed, financed and regulated. An emphasis on benefits for passengers has been pledged, although markedly reduced fares seem improbable.

Successes

In analysing the impact of railway privatisation over a 25-year period, it is clear that there have been real successes, along with the widely reported failures.

Heavy investment – and much needed

Investment levels have been considerable, with much of the capital expenditure being channelled through Network Rail, which in 2019/20 undertook £5.2bn of capital expenditure. But there has been criticism of its capital expenditure management, with serious problems arising on some of its electrification projects.

Inherited backlogs

Nevertheless, both Network Rail and its predecessor, Railtrack, have inherited massive backlogs in seeking to maintain the UK's very extensive track network, not forgetting a vast number of old bridges and tunnels – a process that has led to a safer railway after a sequence of rail disasters a generation or so ago. Furthermore, major schemes, most notably on the much-delayed upgrading of the WCML, have been completed – albeit at a high cost.

ROSCos have invested to modernise the rolling stock

The three ROSCos, which were established at privatisation, have also invested heavily in new rolling stock, where very discernible improvements have been achieved: the replacement of many self-powered diesel units is one such example.

Higher fares and far more passenger journeys

While there has understandably been criticism of the high train fares levied on certain lines, generally at peak times, the additional investment has enabled the pronounced increase in passenger journeys over recent decades.

Sharp rise in passenger journeys

According to data from the Office of Road and Rail (ORR), total passenger train journeys in 2019/20 were 1,742m compared with 1,258m in 2009/10, a decade earlier. For 1999/2000, the relevant figure was 931m, compared with 812m in 1989/90. These figures exclude travel on the Heathrow Express, Eurostar, the Underground and on light railways; non-franchised operator services are also not included.

Sharp increase in service levels

To accommodate more passenger journeys, additional trains have been ordered and 25% more services were rostered between 1995 and 2014, as highlighted by a table in the Interim Shaw Report on *The future shape and financing of Network Rail*.

Although the figures quoted in the table below are all approximate, they do give a guide to the expansionary demand trends on the rail network; subsequently, they came to an abrupt end in March 2020 as the COVID-19 pandemic intervened.

Railway sector key data

Data	Passenger journeys (m)	Track length (miles)	Passenger services per day	Passenger vehicles in operation
1995	735	20,000	16,000	11,000
2014	1,660	22,000	20,000	12,500

Source: Interim Shaw Report

Station modernisation programme

Much of the investment in the rail industry, such as the overhead electrification equipment, is barely seen – or understood – by the travelling public. One exception, though, is the considerable financial outlay to modernise many UK railway stations.

Birmingham New Street transformation

The £750m investment in Birmingham New Street station is an obvious example, as the accompanying image shows.

Birmingham New Street station

Source: Network Rail Media Centre

Bromsgrove now online

Various new stations have also been commissioned, with the one at Bromsgrove in Worcestershire being a good example; it is illustrated below.

Bromsgrove station

Source: Network Rail Media Centre

Many tangible benefits... but flaws

All in all, railway privatisation undoubtedly has yielded some clear benefits, along with the many pronounced shortcomings.

Flaws

Infamous 21/9/2020 announcement

Within the railway franchising system, there were certain inherent flaws, which eventually brought it down altogether, culminating in the 21 September 2020 announcement from a Conservative Government that pioneered the policy in the 1980s and 1990s.

The most egregious shortcomings

Aside from the profound error in preventing vertical integration at the outset – the Isle of Wight excepted – the most egregious shortcomings, which were directly related to the railway franchising system itself, were:

- **Lack of accountability** to passengers for shortcomings, as many TOCs found that Railtrack/Network Rail were directly responsible for an estimated ca.60% of delayed or cancelled services rather than the franchisee.
- **Ticketing problems**, especially for long journeys, caused directly by the shift from a monopoly supplier (British Rail) to franchisees.
- **The complex money-go-round system** devised for railway privatisation saw vast sums of money being circulated around various participants following the break-up of British Rail.
- **Overbidding** for franchises, on the basis that it gave you the best chance of winning – the East Coast Main Line (ECML) seemed fated in this respect, with successive franchise holders making heavy losses and having to retire – or being retired – from the ECML fray.
- **An indeterminate bidding policy** as some franchises were very short-term, thereby discouraging investment, whilst others were too long, which could give rise to years of possible under-performance by the incumbent operator.
- **Compiling credible revenue projections**, which were correlated with projections for the national economy, proved very difficult: forecasting commuter passenger figures was particularly challenging.
- **The complexity and costs of bidding**, as demonstrated by the lengthy – and controversial – saga of the WCML franchise process.
- **The entry of overseas train bidders**, generally offshoots of the local monopoly train company, who benefited from very low public sector borrowing rates. Many became successful bidders, a trend hardly in-keeping with the original railway privatisation principles.

Franchise winners

Stagecoach was first on pole

In the early years of railway privatisation, five bus-orientated companies were successful in winning railway franchises. Stagecoach won the initial South West Trains franchise.

Subsequently, other bus companies, FirstGroup, National Express, Arriva – now owned by Deutsche Bahn despite its ongoing efforts to sell it – and Go-Ahead also became major participants in the provision of railway passenger services.

Given the many negative industry issues, some of these companies have sought to retreat from rail franchising altogether; and, in some cases, they have been negotiating ERMAs with the Department of Transport.

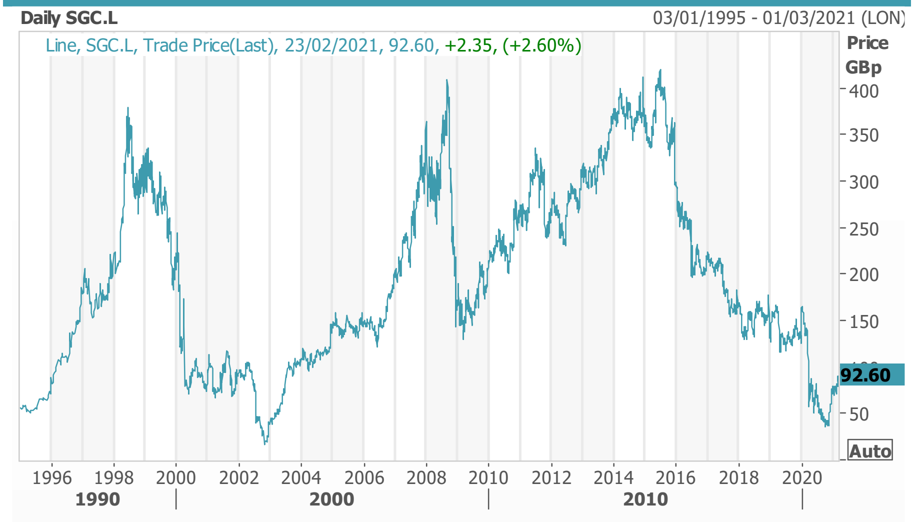
The Stagecoach rollercoaster

The Stagecoach experience is illustrative of the topsy-turvy nature of investing in UK railway franchising, with all its twists and turns. In H1 2020, Stagecoach reported rail revenues of just £2.8m. This compares with a H1 2011 revenue figure, almost a decade earlier, of £525m, which yielded an operating profit of £22.9m.

Stagecoach's zigzag graph

Given that Stagecoach is now primarily a bus operator with relatively predictable revenues, its share price graph, stretching back to January 1995, shows an unusually erratic trend.

Stagecoach January 1995-March 2021



Source: Refinitiv

ca.80% share price plunge in a month for FirstGroup

FirstGroup, a leading railway franchise holder, has also experienced real volatility. Between mid-February 2020 and mid-March 2020, its shares fell by ca.80% as the COVID-19 crisis suddenly deepened. The shares have rallied subsequently, but the inherent instability of UK transport stocks, much of it caused by major changes to the railway regulatory process, is clearly illustrated; to be sure, in FirstGroup's case, other corporate issues overshadow its share price rating.

Winning overseas bidders have also featured prominently, certainly in recent years; they include: Deutsche Bahn, SNCF/Keolis, Trenitalia and Abellio,

More Yeovil than Wembley?

Given that most of these overseas operators will have access to more competitive public funding rates, the issue of whether "a level playing field" is in operation has, not surprisingly, been raised.

And with hindsight…

And if British Rail still ruled the roost…?

In assessing railway privatisation, along with its successes and failures, it is pertinent to consider what would have happened had railway privatisation never been introduced, with British Rail retaining its dominance over the sector.

The evidence would suggest:

- British Rail would have had to fight each year – probably with limited success – against the claims of the NHS, social security, education and others for its share of public expenditure funds;
- lower investment, especially in stations and in rolling stock, would have been likely; whilst the WCML and ECML upgrades may not have even taken place;
- a probable panic-stricken response to the high-profile track and signalling-related rail crashes – Southall in 1997, Ladbroke Grove in 1999, Hatfield in 2000 and Potters Bar in 2002 – with large sums of public money being spent;
- prior to the COVID-19 impact, markedly fewer passengers would have been expected to use the network as low industry standards deterred some potential rail travellers;
- considerably fewer trains would have been scheduled, handling fewer passengers;
- a rapidly worsening financial deficit within British Rail, which would have to have been periodically plugged; and
- minimal support for the HS2 project, given what would have been major financial constraints within the railways sector.

British Rail's woeful public image – and its curled sandwiches…

Of course, the above conclusions are theoretical but – irrespective of the problems of railway privatisation – maintaining, modernising and re-financing the old British Rail, which had a dreadful public image, would have been immensely challenging.

Related issues

Two cash drains

Within the railway sector but outside the franchising process, two other major issues are to the fore – first, the future of Network Rail and, secondly, the HS2 project.

As by far the largest participant in the railway sector, albeit unquoted, improving the performance of Network Rail remains a priority.

Network Rail – the elephant in the room

Network Rail's net debt at March 2020 reached a massive £54.6bn and, given its heavy capital expenditure, it seems set to remain cash-negative. Since its net debt, under international accounting rules, is now deemed to arise from within the public sector, it has been consolidated within the national accounts. In view of its challenging financial situation, it is increasingly difficult to implement major reforms within Network Rail, something that the Shaw Report into the financing of Network Rail addressed.

HS2 obsession – the financial case is flimsy, very flimsy

The government's seeming determination to pursue the highly controversial ca.£100bn London to Manchester and Leeds HS2 project has major implications for the long-term railway network, assuming it is neither cancelled on financial grounds – still a possibility – nor radically re-configured. The benefits, when set against its extraordinary cost, are marginal at best. Like certain EU "grands projets", HS2 will continue to be justified as such and, assuming it is eventually completed, will have consumed vast amounts of cash before transporting a single passenger.

Conclusion

Despite some successes, railway privatisation will be widely seen as a flawed policy not least by the present government, which has effectively reversed it, partly due to COVID-19. The franchising process has proved increasingly controversial, whilst government interventions and U-turns have been very unsettling.

25 years on, happy equilibrium remains elusive

Indeed, even the Shaw Report stated "...since privatisation, the government's involvement in the railway has been constantly changing and adjusting to events, without, so far, ever quite settling into a happy equilibrium".

About the author

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Nigel specialises in the energy sector, with a particular focus on the expanding renewable generation market, both in the UK and overseas, about which he has written several reports assessing the sector's finances.

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