European Rail Policy – British Experience

Chris Nash*

Until 1991, European rail policy accepted that rail transport was a natural monopoly provided by a single vertically integrated government owned company providing infrastructure and train operations. Starting in 1991, policy shifted towards the introduction of competition within the rail sector. This note will concentrate on the experience of Britain, whilst pointing out some key differences from other European experience.

1. Introduction

Until 1991, European rail policy accepted that rail transport was a natural monopoly provided by a single vertically integrated government owned company providing infrastructure and train operations. Legislation required that the rail company be an autonomous unit responsible for its own decision taking and finances. Where the rail company had inherited costs, for instance for pensions that a commercial organisation would not incur, the government should bear them. Where the government imposed public service obligations to provide unprofitable services or charge non commercial fares, the government should compensate the railway company. Otherwise, the railway should operate on a commercial basis.

Starting in 1991, policy shifted towards the introduction of competition within the rail sector. It was recognised that infrastructure was a natural monopoly, but argued that it was possible to have competition between alternative operators over the same infrastructure. EU legislation now requires complete open access for freight and international passenger operators (although some restriction is possible on the carriage of domestic passengers on these trains where this would damage services run under a public service contract). In order to reduce the risk of discrimination, it requires a degree of separation of infrastructure from operations, with separation of decisions on track access charges and capacity allocation from any train operating company and separate accounts. It requires an independent regulator to whom appeals can be made in the case of alleged discrimination. Only now is legislation underway which will require competitive tendering for public service contracts (but with provision for continued direct award of contracts where this process can be justified to an independent authority) and open access for commercial domestic passenger services (subject again to possible limitation where these would compete with services operated under public service contracts).

Already in 1988 Sweden had completely separated rail infrastructure and operations into separate government owned companies and most of Europe has now followed. The alternative which is still permitted is for infrastructure and operations to be separate subsidiaries of the same holding company. This was the model adopted by Germany, Italy, Austria and now France. It is argued by these railways that this permits more efficient planning of investment and use of rail capacity, although this must be done in a way which does not discriminate against other train operators.

Whilst on track competition between freight operators is now widespread in Europe, as noted above neither on track competition nor competition for public service contracts is currently required in the (domestic) passenger sector. However, competition for public service contracts is now the norm in Sweden and is rapidly spreading in Germany; in several other countries it is used for some noncore services. On track competition is also growing with two operators on key routes in Italy, Sweden and Austria and three operators on the most important route in the Czech Republic.

But it is Britain which has taken rail passenger market competition furthest. It no longer has a state owned passenger operator, with virtually all services operated by private companies under franchises awarded by means of competitive tenders. But it also has growing experience of on track competition as a result both of overlapping franchises and of new open access competitors. This note will concentrate on the experience of Britain, whilst pointing out some key differences from other European experience.

2. Rail reform in Britain

Rail reform in Britain essentially took place in the period 1994-7, although there have been significant further developments since. It has to comply with European Union legislation, although the recent decision by Britain to leave the EU means that, when that is implemented, this

* Research Professor in the Institute for Transport Studies, University of Leeds (ITS), C.A.Nash@its.leeds.ac.uk

constraint may no longer apply.

By 1997, infrastructure was separated from operations and placed in a new company, Railtrack, which was privatised by sale of shares. Freight operations were split into two companies and those companies were sold. Passenger operations were divided into 25 companies and these were privatised by competitive franchising. Passenger rolling stock was placed in three separate leasing companies and these were also sold off. Infrastructure maintenance and renewal was also placed in separate companies and sold.

Thus Britain became the only country in Europe to have completely privatised its railway; elsewhere infrastructure and a large proportion of passenger services have always remained in the hands of publicly owned companies. The logic was that competition would be introduced wherever feasible in the structure, not just for all freight and (largely through competitive tendering) passenger operations but also for the leasing of rolling stock and the maintenance and renewal of infrastructure. The one element of the system that was deemed to be a natural monopoly – the planning and operation of the infrastructure – was to be regulated by a new independent regulatory body as now required by EU legislation.

Yet the success of the British approach cannot be described as other than mixed. Whilst the period since privatisation has seen rapid growth in both freight and passenger traffic (not however mainly due to the reforms), there have been considerable problems relating particularly to the efficiency of the infrastructure manager and the successful working of the franchising system. In what follows we will review experience in each of these areas in turn, before seeking to reach conclusions on the way forward.

3. The Infrastructure Manager

At first, separation and privatisation of the infrastructure manager seemed to be achieving its objectives, with efficiency improving (Smith and Nash, 2014). However, there were other signs of problems ahead. Firstly, operators, particularly smaller ones, complained that they were totally dependent on a monopoly provider of infrastructure who was unresponsive to their needs. Secondly, and more seriously, there was evidence that the condition of the infrastructure was deteriorating, with an increased incidence of faults including in particular broken rails. Thirdly, the most important upgrading to which Railtrack was contractually committed – that of the West Coast Main Line – was running late and seriously over budget.

Matters came to a head in October 2000, when a broken rail caused a fatal accident on the East Coast Main Line at Hatfield, for which Railtrack and its maintenance contractors were subsequently found to share the blame. Because Railtrack had no adequate record of the state of its assets, the management panicked and imposed severe speed limits until this could be checked and remedial action taken where necessary. The cost of this remedial action, the compensation it had to pay to train operators and the cost of the overrun on the West Coast Main Line upgrade put Railtrack into financial crisis. It appealed to government for a bail-out, but instead the government chose to place it in administration until it could be taken over by a successor company, Network Rail.

From the first, Network Rail was a curious organisation. It took the legal form of a company limited by guarantee; that is, it was a private company but without shareholders. Instead it had members, selected from the industry and the general public. The government guaranteed all its debts and therefore had powers to intervene if it was in financial difficulties. But otherwise the task of ensuring it operated efficiently fell largely on the regulator. It was argued that this was better than an old style nationalised industry, as the regulator could provide an independent view of the extent to which Network Rail could improve its performance in terms of costs and quality of service. But there is little doubt that the real reason for the choice of structure was that it enabled Network Rail's debt to be regarded as outside the public sector. This was always a controversial issue, however, and in 2014 the British Office of National Statistics decided that in fact Network Rail's debt should be treated as public sector debt. This led to an immediate change in the position of Network Rail, in that it was required to borrow from the government, its borrowing became subject to limits imposed by the government and the government itself began to seek to influence Network Rail efficiency, raising issues of overlap with the rail regulator. Indeed the government consulted on significant changes to the powers of the regulator, but in the face of serious opposition did not pursue these changes.

As has already been noted, there was a substantial increase in Network Rail expenditure after Hatfield and this continued to grow for several years (Smith and Nash, 2014). This led to serious concern on the part of the regulator; benchmarking studies suggested that Network Rail fell a long way short of the efficiency of the most efficient infrastructure managers in Europe. The regulator set tough targets for cost reduction, and although costs were reduced these targets were not met. By 2009, concern about this and the simultaneous growth of costs of passenger train operators (despite the contracts being let by competitive tendering) led to the McNulty (2011) report into the efficiency of the British rail network.

McNulty concluded that costs were at least 30% higher than they should have been, and that a major reason for this was a misalignment of incentives between the infrastructure manager and train operators. Now Britain had done more to try to overcome this misalignment than any other European country. It had a sophisticated system of track access charges which distinguished between literally hundreds of types of vehicle, designed to reflect the damage that vehicle did to the track given its weight, axleweight, unsprung mass, speed and bogie design (although despite this there had been a tendency to introduce more damaging passenger rolling stock as fleet renewal took place, perhaps as a result of the short time horizons of passenger franchisees – Nash et al, 2014). Elsewhere in Europe, track access charges are much simpler, often depending only on train kilometres with little differentiation by type of train. It also had a performance regime whereby whichever part of the railway system – infrastructure or train operator – caused delays, it had to pay compensation for them. This included delays due to track maintenance and renewal work by Network Rail. Such a performance regime is also now a requirement of European policy but most countries were much slower to introduce one and again tended to make it much simpler.

But McNulty saw other major areas in which the problem of misalignment of incentives had not been tackled. For instance, train operators generally only paid marginal cost for train operations (to the extent that there is a two part tariff for passenger franchisees, there is simply a fixed charge that is passed back to government in terms of the bid level of subsidy or premium in the franchising competition). So train operators had no incentive to assist Network Rail in reducing the total cost of the system, for instance by reducing capacity or quality requirements (for example by deferring renewals) even where this was consistent with their needs. Similarly, they had no incentive to reduce the damage done to services by track maintenance and renewals, for instance by investing in rolling stock and staff training which made diversion rather than bus replacement possible, since they would be fully compensated for increased costs and loss of revenue by Network Rail.

In the meantime, a further financial crisis has hit Network Rail. In the run-up to the 2015 general election, the government announced a big increase in rail investment, including electrification of several of the lines that remained in diesel operation. In practice, the costs and timescales for these investments also turned out to be much greater than the initial Network Rail estimates, leading to no fewer than three reviews of Network Rail being set up during 2015, the most fundamental being the Shaw report (Shaw, 2016). This reiterated the conclusion of McNulty that Network Rail should adopt a more regional structure, with only those activities which really needed to be undertaken nationally remaining at headquarters. The Network Rail regions or lines would have their own accounts facilitating benchmarking, and might even be concessioned to the private sector. McNulty had also concluded that they would need to work more closely with franchisees, possibly even forming joint ventures.

In practice the way forward has been the formation of alliances between the relevant regional management of Network Rail and the franchisee. Usually these have only covered specific activities, but in a couple of cases 'deep' alliances have been formed, with a joint management team and a sharing of costs and revenues

4. Franchising

Unlike other European countries, where franchising is only applied to subsidised services, in Britain virtually all passenger services are franchised, including commercial ones. The main exceptions are Eurostar services to the continent via the Channel Tunnel and the Heathrow Express airport service, plus a small number of other open access services which will be discussed further in the next section.

When passenger services were first franchised, the passenger services of the state owned operator, British Rail, were divided into 25 passenger companies following the internal structure of British Rail at the time. Each company served a specific geographical area and a specific type of service (inter city, London commuter or regional). The company winning the franchise took over this train operating company for the duration of the franchise. Franchises were let typically for 7-10 years, on the basis of the subsidy asked for or the premium offered for each year of the franchise. Minimum levels of service were required and some fares (commuter fares and long distance off peak fares) were regulated. Franchisees were responsible for providing rolling stock, which they usually leased.

However, several of the first round of franchises failed because of the failure to reduce costs as forecast. Subsequently, two successive winners of the East Coast franchise, withdraw early in the franchise because of the failure to achieve the forecast revenue growth. As a result, disincentives for early withdrawal were tightened, with not just a performance bond, which would be surrendered but also more substantial requirements regarding the level of financial support that would be given to the train operating company by its parent company in the event of financial difficulties.

The McNulty report favoured longer franchises, with contractualised commitments to reducing unit costs, as a way of strengthening incentives for cost reduction. However, before these changes could be implemented, the Department for Transport experienced major difficulties with the letting of one of the most important franchises in the country – that for the West Coast Main Line. It was found to have failed to follow correctly its own procedures in awarding the franchise, and as a result the award was withdrawn and bidders compensated.

This led to two further reviews of franchising, one specifically on what changes were needed within the Department for Transport to avoid a repeat of these problems, and a wider review of franchising conducted by Richard Brown. In the meantime the letting of new franchises was halted, and existing franchises extended by direct negotiation.

The Brown report (2015) concluded that franchising should be resumed, but at a manageable pace in terms of the number let each year. Brown took a cautious approach to longer franchises, advocating a return to 7-10 year franchises, with the possibility of extensions up to 15 years, but recognising that there might be a case for longer (or shorter) franchises in specific circumstances. He advocated the government bearing risks which the train operator could not influence, and in particular adjustments in payments if GDP growth did not meet expected levels. He also argued that the penalties for early withdrawal were now so large that they were severely constraining the number of companies who had the financial strength to bid for more than one franchise, or indeed to bid at all, and that they should be eased. He saw a good case for franchising of regional services to be undertaken by regional bodies rather than national government.

This is essentially the approach now being taken to franchising. There are now 11 companies involved in rail franchising in Britain, of which four are government railways from other countries. Most of the rest are private bus companies.

As already noted, in those other countries which franchise rail services this has been confined to unprofitable services. Most franchises have been smaller and unlike in Britain there has been no obligation for the new operator to take over the staff of the former state-owned operator or to maintain its wages and conditions. As a result, it appears that franchising elsewhere has been much more successful in reducing costs.

5. Open access

Given that even commercial services are franchised, the current approach in Britain to open access for passenger operators to run services without being awarded a franchise is that these should be limited to cases where they are considered to be attracting significant new traffic to the railway rather than simply taking traffic from the franchisee. The regulator is the judge of this. There are currently two open access operators on the East Coast Main Line, both running from London to destinations not served by regular through services by the franchisee. The regulator has approved application for two further open access services, one on the East Coast main line and one on the West. In all cases, the parent of the open access operator is a major operator of franchised services (either Germany Railways or Firstgroup).

Again, this is totally unlike the situation in the other countries allowing open access competition, where commercial operations are still largely handled by the state owned company without competition for a franchise to do so. In those countries there is no explicit protection for the existing operator, although there may be many barriers to entry, such as difficulties in getting access to infrastructure, stations, depots and suitable rolling stock.

In 2016, the British Competition and Markets Authority issued a report advocating a major extension of on track competition either by easing the rules for new commercial operations to enter the market or by revising the franchising process to create more overlapping franchises (there is already some competition between adjacent franchisees who serve the same cities either by different routes or types of service). Ultimately it might be the case that commercial services would be left entirely to open access operators rather than franchised out. It considered that this would improve cost control, service quality and fares.

6. Conclusions

It will be seen that British experience of rail reform has been far from straightforward; indeed a number of serious problems have emerged. Of these, the most important is the serious cost increases that have occurred. These appear to have a number of causes, including the misalignment of incentives between train operators and infrastructure managers, and the short time horizons of train operators. Possible solutions appear to be the use of longer franchises, deep alliances including revenue and cost sharing between franchisees and Network Rail and the spread of purely commercial open access operations.

In each case, the policy is not without drawbacks. Longer franchises mean longer periods without competition. Deep alliances with the main franchisee may disadvantage freight and other passenger operators over the same tracks. More open access is difficult to accommodate in a railway short of capacity and may lead to a reduction in the quality of integration between different services running over the same tracks.

There is some evidence that the introduction of competition into the passenger sector has been more successful in the other countries that have introduced it, in particular Sweden and Germany in the case of competition for franchises (Nash, C. A., Nilsson J. E. and Link H., 2013) and Italy in the case of on track competition (Croccolo, F., Violi, A., 2013). However, there are significant differences. As noted above, in Sweden and Germany franchises are usually shorter and have more freedom to revise wages and conditions. On track competition in Italy takes place on the new high speed network, which has plenty of spare capacity (except for some problems at terminals), and is competing against a state owned operator that has not had to compete for the right to operate on those routes. With the implementation of the Fourth Railway Package it is likely that there will be a considerable increase in competition both for and in the rail passenger market in the coming years, and more evidence will emerge on what approach works best in different circumstances.

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