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RAILWAY PRIVATISATION AND REGULATION IN GREAT BRITAIN

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The British¹ railway network was privatised in a process that began over 10 years ago. This paper reviews the process of privatisation and the changes that the railway has undergone and the changing level of state involvement and regulation.

One of the main intentions of privatisation of the network was to create a liberalised structure in which private companies could provide railway services to passengers and freight users, with minimal involvement from the state other than its role in specifying and funding socially desirable services. It was expected that this would lead to increased efficiency and responsiveness to changes in market demands. However, since the initial structure was put in place, there has been further change for the industry, culminating in a Government review published in 2004 and new legislation in 2005.

Throughout these changes, one constant factor has been the Office of Rail Regulation (ORR),² the independent economic regulator for the rail industry. ORR was created by the same legislation³ that allowed British Rail (BR), the publicly-owned company that previously ran the British railway system, to be broken up and sold off. ORR's principal responsibility was and still is the regulation of the monopoly and dominant elements of the railway with particular focus on the main rail network infrastructure manager, Network Rail.⁴

ORR has had to do this against a background of changing Government priorities and industry structures, while maintaining our independence in seeking to promote the public interest as set out in our statutory duties. So ORR acts in a sense like a referee in a game of football, to ensure that all the players play fairly and stick to the rules. However, unlike a game of football, ORR is also able to modify the rules, and we also seek to encourage effective relationships between the different companies operating in the sector to ensure that the needs of rail users are met in a way which offers best value for money.

Background

The railways in Britain were originally built mostly without state involvement. Much of the nineteenth century infrastructure, particularly structures, is still recognisable today. Private companies built their own networks, often in direct competition with their rivals, on the basis of private Acts of Parliament. The result was a railway that was not centrally planned, but developed where companies thought that there might be a profitable market. Each major company built its own track, operated its own passenger and freight services and designed and built its own rolling stock (often to unique company standards).

The state took control of the railways during the First and Second World Wars, and promoted a reorganisation in 1923 in which most railway operations were merged into four vertically integrated regional companies. The railways were nationalised in 1948, when BR was formed.

BR was never profitable and received annual Government subsidy despite internal efficiency savings and the sale of non-core activities (such as hotels). In the 1960s and 1970s, the size of the network was reduced by about a third. This contributed to reduced costs, but the network still required state funding, and the Government was forced on several occasions to write off debt. Measures designed to focus subsidy on specific services, for example in the 1968 Transport Act, were also ultimately unsuccessful in creating a more commercial environment and improved efficiency.

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¹ This paper covers the situation in Great Britain, excluding Northern Ireland.

² Initially known as the Office of the Rail Regulator; it was renamed when a Board structure was introduced in July 2004.

³ 1993 Railways Act – since amended by the Transport Act 2000, Railways and Transport Safety Act 2003 and Railways Act 2005.

⁴ Network Rail acquired the previous network operator, Railtrack, in 2002.

In 1992, the Conservative Government manifesto declared its intention to privatise BR. The aim was to reduce State involvement in the railway, reduce the burden on taxpayers and bring in private sector funding and expertise. The railways were the last of the major privatisations which had started with the privatisation of British Telecom in 1984, and continued with privatisation of the gas, water and electricity networks.

Privatisation and regulation of the railway

As well as the last, the railways were the most complex and most politically divisive. Unlike the other companies that had been privatised, BR was dependent on Government subsidy to operate and was expected to remain so when in the private sector. The privatisation also involved the biggest restructuring, with one integrated company being replaced by over 100 separate companies, held together through a complex set of contractual relationships, many requiring the approval of ORR and by licences enforced (and where appropriate modified) by ORR.

Three models of privatisation had been considered before deciding on this approach.

The first was to sell off the whole company as a single entity, with no rail competitors (though of course rail is in competition with other modes of transport). This model had been used for the sale of British Gas, but was criticised for moving a monopoly from the public to the private sector, and not introducing real competition. In the case of British Gas, the result was a decade of confrontation with its regulator, leading to numerous references to the Competition Commission,⁵ the introduction of domestic competition and the demerger into three successor companies covering gas exploration, transmission and distribution, and gas supply.

The second model was to break BR into several regional companies, in some ways replicating the situation before the railway was nationalised in the 1940s. This is essentially the structure that still exists in the privatised water industry in England and Wales. This model, which was also used for the privatisation of Japan Railways, was rejected for creating regional monopolies and not introducing competition.

The third option, the one that was adopted, was the “Track Authority” model. BR was vertically separated, with a new private company, “Railtrack”, owning the infrastructure and charging train operators to have access to the network. Although there was initially a view that Railtrack might be retained as a public sector company, it was floated on the stock market in 1996. The track and infrastructure maintenance activities of BR were divided into several companies and also sold off, mostly to construction companies, with contracts to supply services to Railtrack. In parallel, franchises to run passenger services for periods of between 5 and 15 years were also tendered by a public sector body, the Office of Passenger Rail Franchising (OPRAF). Some of these franchises were awarded to management teams, but many were awarded to bus companies.

Railtrack was a monopoly and, as with other privatised infrastructure companies, the privatisation legislation created an independent economic regulator to ensure that it did not abuse its monopoly position. ORR was given the role of regulating the company through enforcing conditions set out in the licence the company was required to have to operate the network.

As part of its regulation of Railtrack, ORR also needed to establish the charging framework that determined the track access fees that the company could set. The charging framework would allow Railtrack to recoup its efficient costs as well as providing a return on its capital. The framework of track access charges is generally fixed for a five-year period, after which it was to be reviewed by the regulator. Following the initial establishment of the charging framework in 1995, a periodic review took place in 2000, with a special interim review taking effect in 2004. The next periodic review of charges will take effect in 2009.

ORR also has a role in ensuring that the network is being operated effectively and fairly in approving all track access contracts. In addition, it has concurrent competition powers for railway services with the Office of Fair Trading (the national competition authority).

At the time of privatisation, there was considerable debate about the appropriate extent of competition between train operators. To be eligible for subsidy, passenger services have to be operated under a franchise agreement. There were initially 25 franchises, with franchises being awarded to operators that of-

⁵ Previously the Monopolies and Mergers Commission.

ferred the best value, generally in terms of the lowest level of subsidy (or in a few cases the highest premium). Except where franchises overlapped (with, for example, services from London to Birmingham being provided by three different operators), there were initially restrictions on the ability of so-called “open access” operators to seek access rights to run competing services. To date, there has been only one open access operation of any size, which runs services without subsidy from Hull to London (a route not served well by the relevant franchise).

In contrast, there has been competition in the provision of rail freight services from the start. The freight division of BR was sold off as six separate companies, with the individual companies free to negotiate access with Railtrack. Although in the event five of these companies were acquired by the same owner, other operators have since entered the freight market and have been successful in winning business from other freight operators, as well as bringing new business to rail.

Although Railtrack and all train operators require a licence to provide services, other companies spun out of BR generally do not. These included the companies providing maintenance and renewal services to Railtrack, and the Rolling Stock Companies (ROSCOs), created to own all rolling stock and finance new rolling stock, and lease it to train operators. Three ROSCOs were created at privatisation, and their activities are “regulated” only through general competition law.

Restructuring of the industry

The first years of the railways in the private sector were generally positive. Passenger numbers grew, as did the amount of freight carried. Additional services were introduced on the network. New passenger freight and freight rolling stock were also introduced. Passenger-kilometres have increased by 35 percent from 1994–2004 and freight tonne-kilometres increased by 40 percent over the same period.

Railtrack’s initial performance as a private sector company also appeared to be positive. However, a series of events began to undermine confidence in the company. The company embarked on a major development of the West Coast main line, the key strategic route to Scotland from London via Birmingham, Liverpool and Manchester. The development of that

route was intended to renew and upgrade the infrastructure, resulting in faster journey times, improved reliability and increased capacity. The initial project was very ambitious, and the target improvements were delayed and were subject to significant cost overruns.

Although passenger numbers grew, the franchises were also not without problems. Some of the earliest franchise bidders found that they were unrealistic in their projections. Several franchise operators sought to renegotiate their franchise agreements, and some were allowed additional subsidy.

A major feature of the British rail network in the ten years since privatisation has been the increase in costs. The rise in costs has been attributed to several factors, including higher safety standards, new legislative requirements for example in respect of accessibility of trains and stations, growing risk aversion, and poor cost control and asset knowledge on Railtrack’s part. This was in some part due to the way in which maintenance was contracted out, which resulted in a loss of control by Railtrack of key information on its assets. ORR recognised this last failing and strengthened the company’s licence; however, Network Rail decided in 2004 that maintenance should be brought back in-house, and this transition has now been completed.

Public confidence was eroded in the railways in general and Railtrack in particular by a series of fatal accidents between 1997 and 2000. Following a fatal accident in 2000 at Hatfield, north of London, a large number of speed restrictions were placed on the network. Performance suffered dramatically, costs escalated and Railtrack’s share price fell. This culminated in 2001 when Railtrack was placed into Railway Administration and was ultimately acquired by Network Rail, a company limited by guarantee, owned by about 115 “members” rather than by shareholders.

Before this, the change of Government in 1997 had led to a review of the structure and regulation of the railway industry. The new Government concluded that the public sector structure that it inherited was not fit for the purpose. It created an agency to plan the long-term future of the railway, the “Strategic Rail Authority” (SRA), which took on the franchise award and monitoring functions of OPRAF. The creation of the SRA was an acknowledgment by the Government of the need for a longer term strategy, while retaining the structure of private sector provision put in place at the time of privatisation.

In 2004 the Government announced a further Rail Review, prompted by concerns about the deterioration in performance and escalation in costs since the Hatfield accident and reflecting the other changes in the industry, including the replacement of Railtrack by Network Rail. In the conclusions to the review, published in July 2004, the Government decided to change again the responsibility for rail strategy, bringing this back within central government. As a consequence, the SRA was wound up and its franchising functions were also brought inside the Department for Transport. Network Rail was given additional responsibility for the overall operation and performance of the railways, as well as responsibility for developing Route Utilisation Strategies – medium term plans for each part of the network reflecting increasing demands and the steps needed to meet that demand while maintaining and improving performance. ORR modified Network Rail's licence in 2005 to ensure that it carried out these new responsibilities effectively.

The review confirmed the Government view that independent economic regulation of the industry was essential – a view shared by the majority of the rail industry. The review also concluded that safety regulation of the railways should transfer to ORR from the Health and Safety Executive. Her Majesty's Rail Inspectorate will therefore transfer to ORR in the early part of 2006, so that ORR becomes a combined safety and economic regulator.

The aim of these changes is essentially two-fold, which is recognised in the description of the railway as a “public and private partnership”, involving “public specification and private delivery”. The new arrangements reinforce the responsibility of Network Rail and train operators to work together to deliver improved performance and efficiency in a way which meets the requirements of rail users. But they also place a clear responsibility on Ministers – a responsibility now reflected in the Railways Act 2005 – to set out a “High Level Output Specification” of the rail services it wishes to fund, and the funding available, as an input to ORR's periodic review of Network Rail's outputs and allowed revenue.

The role of ORR

The review therefore confirmed the continuation of a “triangular relationship” between the Government, Network Rail and the franchised train operators with

ORR playing a key role in ensuring that these relationships operate effectively and fairly.

The relationship between Network Rail and the train operators is set out in access contracts. ORR reviews and approves these contracts as well as any changes to the Network Code, the industry wide agreement that is part of each access contract that ensures that the interests of all parties are taken into account in the daily operation of the railway. The access contracts also set out the details of the performance regime. The performance regime is the part of the access contract that penalises poor performance with financial penalties. If a service is delayed due to a failure of the infrastructure, then the infrastructure manager compensates the operators that are affected. The same is also true of delays caused by other operators.

The relationship between the Government and Network Rail is another key feature of the railways and is described in the review conclusions as a “binding arrangement” to ensure that Government gets value for the public money it is putting into the railway. But this is not a contractual relationship. As explained above, the Government determines what level of support it will give to the railway and what its priorities for service delivery are. The outputs the Government wants are set at a high level and will in future take account of the Route Utilisation Strategies developed by Network Rail. Detailed delivery plans are then established for Network Rail through its regulatory framework monitored and enforced by ORR and by the franchised passenger operators through franchise agreements.

The third leg, between the government and the franchised passenger train operators, is the one where ORR has the least direct involvement, but still plays an important role. This relationship is determined by the franchise agreement which sets out the service levels required from each operator and the level of subsidy (or return to the government) that each franchise require. Each train operator also has a licence granted by ORR and subject to a set of conditions. ORR also ensures that the needs of other users of the railway, especially freight, are not ignored. ORR achieves this by approving all access agreements to the network and determining the framework for access charges. As part of this role, ORR has reviewed the format of access agreements and also encouraged the industry to review the multi-lateral arrangements in the Network Code to ensure that responsibilities of train operators and of

Network Rail are clear and that all companies involved in providing services to rail users can work together to deliver improved performance and efficiency. These changes have continued following the rail review, for example with a move towards integrating Network Rail and train operator control rooms, to allow more effective real-time management of train services.

Taken overall, the changes in the structure and regulation of the rail industry in Britain anticipated much of the EU legislation that aims to reform and revitalise the railways. For example, rail privatisation introduced the vertical separation of the railway industry (though EU provisions do not require privatisation), the encouragement of new entrants into the market, the licensing of railway undertakings and the creation of an independent regulator to act as appeal body. These regulatory bodies have now been created in each member state that has a railway and are cooperating with each other to ensure that international, as well as domestic, rail services are operated in an environment that is fair and open. In Britain the new European legislation extends our powers to previously unregulated facilities, such as the Channel Tunnel Rail Link.

Conclusion

The privatisation of BR transferred the ownership of the railways from the public to the private sector. At the same time the government created a regulatory structure that would ensure that the railways fulfilled the various public obligations that were required of it. The initial structure has been amended several times since privatisation to ensure that it is fit for purpose. In particular, it is important that different companies operating in a network industry work together to deliver the performance and efficiency that customers rightly demand. This requires an appropriate set of contracts and licences, and effective partnership, as now exists in Great Britain.

Our vision is for the mainline railway industry in Britain to be one in which Network Rail, train and freight operating companies in partnership with public sector funders, and the railway supply industry, work together to meet the current and future needs and reasonable expectations of passengers and users by providing safe, high performance, well maintained and efficient railway services that offer value for money for passengers, other users and funding organisations. That vision underpins our approach as the independent economic – and in future also the safety – regulator for the railway.