

# **Privatization and Deregulation of Transport**

Edited by  
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Transport Regulation  
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Final draft text follows.

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13 August 1997

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ESRC/RPRC Seminar on Privatisation & Deregulation of Transport

Dear Sharon,

In response to Helen's telephone call, enclosed please find a final hard copy of my paper. This was prepared in Word Perfect 7.

As requested, I have enclosed a copy on diskette in Word format however the tables and footnote formats have not transferred entirely so you will need to do some tidying.

Thank you for the opportunity to participate in this project.

Sincerely

Michael Schabas

**COMPETITIVE BEHAVIOUR**  
In Britain's Privatised Rail Industry

ESRC/RPRC Seminar on Privatisation and Deregulation in Transport  
Hertford College, Oxford  
July 2 - 4 1997

Michael Schabas, Director  
GB Railways Group Plc

## 1 Abstract

Although there remain many parts of the passenger railway industry which are natural monopolies, the Government's chosen fragmentation and franchising structure has created competition on many levels. This paper first surveys the success at creating and maintaining competition in the bidding for passenger franchises and for the acquisition of other businesses formed from British Rail. Second, we look at apparent moves by industry players to gain market control, in ways which might be considered anti-competitive. Third, we look at the regulatory responses to date.

## 2 Competition for the supply of railway services

In devising the restructuring of the British railway industry, Government sought to create effective competition wherever possible, both in the supply of railway services to passengers and freight shippers, and in the inputs to the operators of the railway services. The unitary British Railways Board was broken into approximately 100 companies. These were then vested and sold, usually by competitive tender.

### 2.1 Vesting and Shadow Running

During the vesting process, Government attempted to balance two fundamentally conflicting objectives. On the one hand, proceeds to the Government could usually be maximised if companies were sold as protected monopolies. On the other hand, experience had shown that the benefits of privatisation would be greatest if the new companies were exposed to competitive as well as (or even instead of) regulatory discipline.

The pragmatic response was to vest the ex-BR companies with contracts in place, ranging up to ten years in length although usually only lasting two to four years. Often the extent or scope of the vested contracts also declines within the overall contract term. As there are in most cases lengthy lead times for competitors to acquire the necessary equipment and know-how, the contractual and regulatory restrictions that are in place may be more in the nature of comfort to purchasers than materially delaying emergence of real competition.

A distinction is required between the 25 franchised passenger Train Operating Companies (TOCs), in which Government has a continuing financial interest, Railtrack which is a regulated monopoly, and the "non-core" service and supply companies which are not regulated but which are nevertheless major suppliers to the TOCs and Railtrack.

If the TOCs and Railtrack were locked into monopolistic suppliers, then this would limit the potential to reduce subsidies to TOCs. Thus the Infrastructure Maintenance Units were vested with contracts protecting most of their initial workload for five to seven years, but with a declining schedule of prices to reflect expected efficiency gains. The Track Renewal Units have their protected workload decline more rapidly, with none

contracted at vesting beyond the end of the fourth year. The majority of rolling stock leases extend until 31 March 2004, however some expire as early as 1998 and others can be terminated without penalty by 2000.

All companies were vested over a two year period 1994-1996. Management teams drawn primarily from within British Rail were assigned to each company, to negotiate internal trading contracts with other ex-BR companies. Only a few non-core companies were sold in 1994-1995, with BR insisting that a complete contract matrix (or nearly so) be in place before sales of the TOCs could proceed in earnest. At the time, this insistence on a “shadow running” period was criticised as causing delay, however it appears to have proven successful as few problems have subsequently emerged and prices obtained for the businesses generally exceeded expectations.

## 2.2 Management Buy-Out Bids

Management teams were invited to form companies to bid for their own newly-formed businesses, and British Rail was authorised to provide up to £100,000 towards each Management Buy Out (MBO) team to cover out-of-pocket expenses such as legal and accounting fees. This served three purposes. First, it satisfied a political desire to empower railway managers, so that privatisation could be described as a devolution of responsibility. Second, it increased the competition for the businesses, as there would then usually be at least one serious bidder. Third, and perhaps most important, it gave management a strong incentive to ensure that a robust matrix of contracts was indeed in place. This gave comfort to outside bidders that the business were, indeed, sound enterprises.

## 2.3 Sale of the Franchised TOCs

The actual sale of the TOCs commenced in 1995 and continued through into early 1997. The sale process was managed for the Franchising Director by the Office of Passenger Rail Franchising (OPRAF), of which he is the head. OPRAF was supported in the sale process by the Corporate Finance divisions of various merchant banks and accounting firms.

The franchising process was structured as a series of competitive tenders, but was in fact a combined sale of the TOC business units together with award of a Franchise Agreement which is really a form of service contract. After an initial screening to establish a level of technical and financial competence, pre-qualified bidders were provided with a “Long Form” report, disclosing detailed financial information on the performance of the TOC over the period of shadow running and before, if available. There was also a Data Room containing TOC contracts and other materials, and an opportunity to meet with TOC management under OPRAF supervision.

Bidders were invited to submit an Indicative Bid setting out their approach to the franchise, and presenting detailed financial projections including the level of subsidy that would be required. A shortlist of three or four bidders were then invited to complete final

“due diligence” and submit final, binding bids. The successful bidder purchased the TOC, together with all contracts, employees and assets which were vested in it, for a nominal £1 (after “zeroisation” of the TOC balance sheet, so that there are no net assets). At the same time, the bidder entered into a Franchise Agreement with OPRAF normally for a period of seven to fifteen years.

Although the Franchising Director has considerable discretion in award of franchises, in practice it appears that he followed quite strict and straightforward criteria. In all cases it would appear that the franchise was awarded on a financial basis. All bidders were required to commit to deliver at least the full Passenger Service Requirement, and to maintain or improve existing performance standards. While many bidders volunteered additional service enhancements, in most cases these seem to have been financially self-supporting. The author is not aware of any case where a franchise was awarded other than to the bidder asking for the lowest subsidy or offering the highest level of premiums, when discounted by OPRAF to a Net Present Value at 6% real. Many successful bidders have made binding commitments also to invest in improved services, but it appears that these commitments are (or were when they were made) believed to be commercially worthwhile or, at worst, financially neutral.

During the passage of the Railways Act, there was much scepticism that Government would find companies willing to take on the TOC franchises. Clearly, these were new businesses without an obvious model, and with a somewhat unusual mix of risks and opportunities. In practice, Government always received at least four initial bids for each franchise, although for a few of the early franchises only two or three reasonably compliant bids were actually received. Early in the process, declared interest was limited to a few existing transport companies. This included bus companies which had emerged from the earlier privatisation of that industry, together with Sea Containers, a shipping company which had played a role in privatisation of British Rail’s cross-channel ferries in the 1980s, and Virgin Group which is probably best known for its airline business.

Later, others joined in the bidding although many did not publicise their interest until well into the process.

Table 1 presents information on the 25 franchises and their new operators. While there is a heavy presence of bus companies, who are involved directly or indirectly in 18 of the 25 franchises, some of the largest franchises are owned by non-bus companies. The largest player in the London suburban market is Connex, a subsidiary of the French utility Groupe Générale des Eaux. More than half of the long distance market is controlled by Virgin Group, followed by Sea Containers. National Express has a mix of local and long distance routes, to complement their local and long distance bus operations and regional airport portfolio. Besides companies with existing transport interests, two completely new companies were launched, both now listed on the Alternative Investment Market (AIM), the “junior market” of the London Stock Exchange.

Table 2 presents subsidies for the 25 franchised TOCs, for selected years. Note that the actual subsidy that is paid will vary as follows:

annual subsidy payments will vary by a few percent depending upon actual train performance;

subsidy payments may be adjusted after 2002 to reflect possible adjustments in Railtrack charges and change in on-track competition policy. In each case the Regulator has not yet set his policy;

actual subsidy payments are subject to inflation.

Table 1 The Franchised Train Operators

Franchise	Operator	Passenger Revenue 1997 £m
South Central	Connex (CGEA, a division of Group Generale des Eaux, a diversified French utility)	

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South Eastern	Connex	248
Great Eastern	First Bus Plc (urban bus operator)	130
Great Western	Gt Western Holdings (First Bus with Management Buyout)	183
NW Regional Railways	Gt Western Holdings	50
West Coast	Virgin Group (Venture/Private Capital)	241
Cross Country		116
Scotrail	National Express Group Plc (diversified transport business - coach/bus/airports)	110
Central Trains		72
Midland Main Line		71
North London		56

Gatwick Express	32	
South West Trains	Stagecoach Holdings Plc (coach/ bus/rolling stock leasing)	285
Island Line	1	
Great North Eastern	Sea Containers Ltd (shipping/ hotels/ luxury trains)	257
LTS Rail	Prism Rail Plc, new company floated on Alternative Investment Market.	55
W Anglia Gt Northern		130
South Wales & West		48
Cardiff Railway		7
Thames	Victory	
(Go Ahead Group Plc with MBO)		61
Thameslink	GOVIA (Go Ahead Group with Via GTI, a French bus and rail operator)	93
Regional Railways NE	MTL Trust Holdings, an urban bus operator	75
Merseyrail		20
Anglia GB Railways Group Plc, a new company floated on Alternative Investment Market		41
Chiltern	MBO with John Laing, a construction contractor/infrastructure developer	29

It is possible that some franchises will be terminated early, either because the operator is in breach or, perhaps more likely, because he is in danger of financial insolvency. Before awarding each franchise, OPRAF has reviewed the financial projections to ensure that bidder assumptions are reasonable. However, the Franchising Director has at least four mechanisms to protect against financial insolvency:

First, before a franchise is awarded the Franchise Operator (FO) must provide capital equivalent to about 15% of passenger income. Half of this must be in the form of a bond, while half may be used as working capital. The requirement to put up millions or tens of millions of pounds must guard against cavalier bidding. In the event that an operator does choose to “walk away” from a money-losing franchise, OPRAF can use this capital to relet the franchise. The capital also provides a financial cushion should an otherwise sound franchise encounter short-term problems;

Second, an operator with more than one franchise may be required to cross-collateralise, so that it may not withdraw from one franchise without forfeiting all of its franchises;

Third, a franchise operator with ambitious investment commitments, such as rolling stock replacement, will likely need to enter into commitments to pay lease charges at least for the full duration of the franchise. Thus the financial loss to a company which “walks away” from a money losing franchise can be substantially greater than the franchise capital;

Fourth, all franchises are subject to regular audit by OPRAF which can, therefore, take remedial action if financial problems are evident.

Note that the 25 franchises are now controlled by 11 to 13 distinct groups, depending upon how one treats interlocking interests.

Table 2 Subsidies for the Train Franchises

**Again, you need to redo this table to look like the conference text**

Franchise (years) (note 1)	Length Subsidy (Premium) 1997 £ millions (note 2)				Other Key Franchise Commitments
	1997	2003	2011		
South Central	7	85	35	(35)	
South Eastern	15	125	27	(3)	Replace slam door stock by 2006
Great Eastern	7	41	(5)	(24)	
Great Western	10	60	35	(10)	Half hour frequency to Bristol
NW Regional Rlwys	7	192	130	108	Replace old trains
West Coast	15	93	(4)	(202)	New tilting train fleet by 2002
Cross Country	15	127	49	(5)	Total fleet replacement by 2004
Scotrail	7	292	208	170	Replace old trains
Central Trains	7	198	137	118	
Midland Main Line	10	17	(4)	(20)	New fleet for local stops
North London	7	55	20	(20)	Replace old trains
Gatwick Express	15	(5)	(12)	(23)	New fleet by 1999
South West Trains	7	60	40	(25)	
Island Line	5	2	2	2	
Great North Eastern	7	65	0	(19)	
LTS Rail	15	30	19	11	New fleet by 1999
W Anglia Gt Northern		7	71	(14)	(32)
South Wales & West	7	77	43	29	
Cardiff Railway	7	22	14	6	
Thames	7	44	4	(11)	
Thameslink	7	16	(27)	(30)	
Regional Rlwys NE	7	223	151	124	Replace old trains
Merseyrail	7	91	62	48	
Anglia	7	41	9	(10)	New fleet by 2000; half-hourly to Norwich
Chiltern	7	17	3	(11)	New trains; hourly to Birmingham
PTE Revenue		(86)	(97)	(114)	
Net Total Subsidy			1,952	820	23

Notes to Table 2

1. Extension of the LTS, Midland, and Great Western Franchises beyond 7 years are conditional upon investment in improved rolling stock.

2. Where a seven year franchise has been awarded, subsidy for 2011 is the author's projection, shown in italics.

3. For the North London, Central, North East, North West and Scotrail franchises, some or all of the revenue risk was retained by local Public Transport Executives. Subsidy for the franchises is presented before PTE revenue, which must be subtracted to give the net subsidy from Government.

#### 2.4 Sale of Other Businesses

In parallel with the sale of the franchised TOCs, British Rail sold off the 60-odd subsidiary companies which had been established. These supply everything from trains to sandwiches to the franchised TOCs. It also sold off the companies which maintain tracks and trains, and which operate freight services. Altogether, the companies on sale had turnovers including trading with each other worth in excess of £4 billion. Given the complexity of internal trading, the process could be compared with privatisation of the economy of a middle-size eastern European state.

Where practical, two or more companies were created for each business activity, often following pre-existing management divisions. This would provide an immediate level of competition, if sold to separate buyers, and would also make the companies more "bite size" and thus suitable for a range of buyers with different financial and market appetites.

In practice, a degree of reconsolidation has been tolerated and was probably always expected. This will be considered later.

#### 2.5 Privatisation Balance Sheet

The privatisation of British Rail is remarkable in that a money-losing, subsidised industry has been sold in a manner which is cash-positive to Government and which will remain so compared with other alternatives.

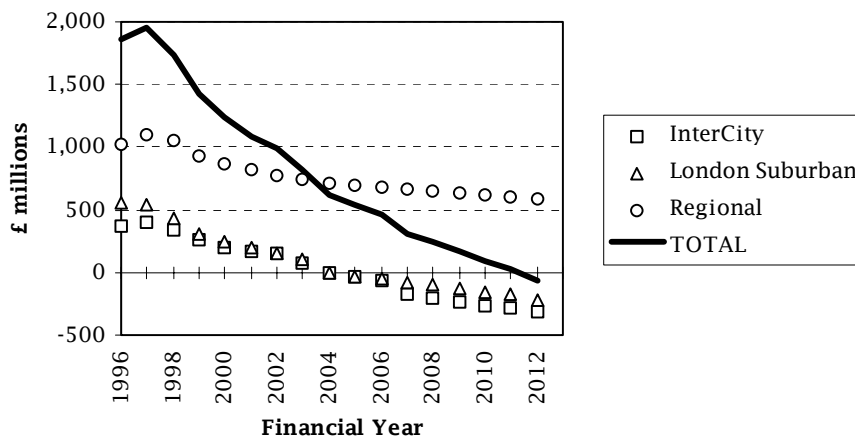
Since nationalisation, British Rail has required increasing levels of subsidy, at least in nominal terms. Although there has been some significant investment and services have, slowly, improved, this was never at a pace that was considered acceptable to the public or indeed to Government. Despite continuing rationalisation and productivity improvement, it was difficult to reduce the operating subsidy below £1bn per year. Although BR managers had much to be proud of, they had reached the limits of what could be achieved with a centrally-managed, government owned monopoly. Allowing for "steady state" renewal of infrastructure and other capital assets such as trains, without restructuring and privatisation Government could expect a liability of about £1.5 bn per year indefinitely, with only slow service improvement and no prospect of satisfying public or political expectations.

Restructuring is understood to have cost about £400 million, mostly in fees to lawyers, accountants, and other advisers. Sale of assets, including the ROSCOs, Railtrack, and various non-core businesses, has generated about £4 billion in cash. Annual subsidies have increased, from the (inadequate) £1 billion which government was paying to BR in the early 1990s, to almost £2 billion in 1996-7.

Some rail privatisation critics have pointed to this increase in “headline” subsidy as evidence that privatisation is costing taxpayers money. However, net contracted subsidies will decline rapidly, to below £1 bn in 2002 and, potentially, to nothing by 2012. In that year Britain’s railways will, taken as a whole, require no government subsidy whatever. In fact, since most of the railway companies will be paying tax, the industry will be cash-positive to the Exchequer from an earlier date. Treating the £4bn sales proceeds as a “sinking fund” to pay the higher subsidies in the early years, the privatisation will always be cash positive and will bring fiscal benefits worth several billion pounds in later years.

Privatisation should also bring real benefits to rail passengers and the country as a whole. Most franchise operators have made commitments to deliver service improvements far in excess of what could have been reasonably expected if BR remained in public ownership. Britain already has one of the most modern train fleets in Europe, with high frequency services on the most routes. Franchise operators are committed to refurbishing or replacing most of the remaining aged rolling stock, and to increase service frequencies on many routes. Just as privatisation has brought Britain the best telecoms and air transport services in Europe, with profits for shareholders and tax receipts for Government rather than subsidies, so rail privatisation will do the same.

Figure 1 Contracted and Projected Subsidy for the Franchises



Notes to Figure 1

1996 to 2003 - based on contracted subsidies

2003 to 2012 - combination of contracted subsidies and author's projections

### 3. Anti-Competitive Behaviour and Regulatory Protection

On offer at the beginning of 1995 were:

twenty five passenger franchises, based on "bundles" of routes;

three rolling stock leasing companies, newly created;

one network operator (Railtrack);

six heavy maintenance depots;

six infrastructure maintenance units, based on geographic territories;

five track renewal units, based on geographic territories;

three trainload (bulk) freight companies, based on geographic territories;

one domestic container freight company;

one parcels business;

one international (channel tunnel) freight company;

one express freight (mail) train operator;

two signal engineering companies, based on pre-existing separate design offices;

five civil engineering design companies, and three rolling stock engineering companies, based on separate design offices operated by BR's InterCity, Network Southeast, and Regional Railways business sectors;

one computer systems provider.

There has subsequently been a degree of consolidation although only a few cases have attracted attention or concern.

#### 3.1 Vertical "Integration" of ROSCOs and TOCs

The three rolling stock leasing companies were sold separately and Government insisted from the start that no purchaser would be allowed to acquire more than one. However one

ROSCO, Porterbrook, was subsequently acquired by Stagecoach which also operates the South West Trains franchise and was, at the time, bidding for several other franchises as well. Concern was expressed at that time that Stagecoach would use its market power in an anti-competitive manner. However it remains unclear how it could do so. The Franchising Director already has safeguards in place to ensure incumbent operators must offer rolling stock to successor franchise operators on reasonable terms. A “Direct Agreement” is required between OPRAF and any major supplier to a franchised TOC, to facilitate re-letting of the franchise on a competitive basis.

While it would be difficult to ensure that Porterbrook did not offer its parent more favourable terms than to competitors, if this is a concern it is likely that the Franchising Director would simply refuse to invite Stagecoach to submit a bid for the franchise renewal.

As an apparent “sweetener” to encourage approval of the Porterbrook acquisition, Stagecoach entered into a commitment to acquire some new rolling stock for the SWT franchise. This contract was in fact awarded to Porterbrook although Stagecoach did invite competitive bids.

Around the same time as Stagecoach was acquiring Porterbrook, Connex (a division of Compagnie Generale des Eaux) was acquiring the Southeastern Franchise. This franchise is for 15 years and includes a commitment to replace about half of the rolling stock, with a notional value of £250 million. One reason Connex may have won this franchise is its ability to acquire new rolling stock on its own balance sheet, taking residual risk itself. Connex can take a positive view of residual value because it expects to remain in the business of operating trains beyond the life of the initial franchise.

Connex has not, yet, acquired the new trains and it remains to be seen whether they will acquire them on its own book. Whatever it decides, there is no obvious reason why it should be more confident of winning the franchise extension than another bidder. It must enter into the same direct agreement, making the trains available in fifteen years to any subsequent franchise operator.

Connex has taken two risks, one to operate a franchise and one to own and lease trains, albeit to itself for the initial period. If ownership of the trains does offer a real competitive advantage when the franchise is up for renewal in 2011, then OPRAF may need to exclude Connex from the bidders as otherwise it will be unable to create a genuine competition.

Although Stagecoach and potentially Connex have taken ownership of two levels in the industry, they have not yet succeeded in vertical integration in a way that should seriously limit participation at either level of non-integrated players.

### 3.2 Consolidation of Freight

Five of the six rail freight businesses have been acquired by one group, English Welsh & Scottish Railway which is led by Wisconsin Central. EW&S initially acquired Rail Express Systems (Res) and then subsequently put in the highest bid for all three trainload freight companies. It later purchased Railfreight Distribution, operating intermodal services through the Channel Tunnel (although this remains subject to EU approval). Of the ex-BR freight companies, only Freightliner escaped the EW&S net, going instead to an MBO team.

The public debate on this focused on two issues:

First, why had Government spent money splitting trainload freight if reconsolidation was then to be allowed?

Second, was competition between the freight companies always misguided if most competition was actually with road haulage?

Both debates obscured more meaningful issues. The costs incurred in splitting Trainload Freight into three businesses were tiny, compared to the sale proceeds which exceeded £250m. By splitting Trainload Freight into three companies, Government made it into pieces that were digestible by more bidders, thus creating keener competition. All three Trainload Freight companies had in place management teams which each could and did launch bids for their own companies and for each other. Had Trainload Freight been kept as a single company, Government would probably have received much less from the sale as there would have been few interested bidders.

The road versus rail debate was also confused. It was never suggested to split Res, Freightliner, or RfD. All three operate as integrated national networks serving many small flows. These business do indeed operate in direct competition with road for most of their traffic, and splitting them would reduce their ability to offer a complete product range to shippers. Indeed, these business will probably now expand both vertically, into road haulage, and horizontally into international routes.

However Trainload Freight carries, as its name implies, bulk loads such as coal, chemicals, building materials or foodstuffs where rail often has a decisive cost advantage over road. In most cases, trains are dedicated to specific flows, for example from a quarry to a city, or from a port to a power station. Sometimes two or three flows can be combined to share traction locomotives, but with modern specialised rolling stock there are usually few network synergies between different flows. As a consequence, there are also few real barriers to entry. Indeed, there are three independent heavy haul operators which were never in BR ownership. Mendip Rail is owned by a consortium of aggregates and building material companies. National Power operates its own trains to carry coal to electricity generating stations. British Nuclear Fuels operates its own trains to carry nuclear flasks.

It seems clear that splitting Trainload Freight into three companies helped Government achieve a higher sale price. At the same time, reconsolidation has not posed a problem as there is a demonstrated ability of new operators to enter the bulk rail freight market.

### 3.3 Multiple franchises and On-Track Competition

The 25 passenger rail franchises have now been acquired by 11 groups or companies. It was always expected that companies would seek to acquire franchise “portfolios”. Apart from sharing head office overheads, there are probably few economies in owning more than one franchise. Considerable care has gone into protecting individual operators from predatory or exclusionary behaviour, and there is indeed a specific prohibition on exclusionary behaviour in the template Franchise Agreement.

However there are advantages to investors in owning portfolios with different risk profiles. For example, traffic on London commuter franchises is affected directly by changes in central London employment. In 1990-1994, traffic on some routes declined by as much as 35%. In contrast, traffic on InterCity and Regional (non-London) routes declined much less.

While “Head Office” costs as such are fairly small, there appear to be real advantages in sharing head office skills and strategic resources. Just as a small number of large property developers are active in each major city, so a small strategic team can apply its skills to acquiring and guiding a portfolio of franchises.

When shortlisting bidders for each franchise, OPRAF was concerned primarily with getting the best value for the taxpayer, that is minimising subsidy or maximising premiums. However the Regulator made it clear that he wanted to encourage the growth of on-track competition.

While the 25 TOCs are often characterised as protected monopolies, there are a significant number of flows where they already compete with each other. For example, commuters often have a choice between using suburban and long-distance trains. Since management performance within BR was monitored in part by revenue growth, there has always a degree of covert “raiding”, but competition with another sector of BR was not in the corporate interest and was frowned upon, even if it might benefit passengers. Once the TOCs were split and sold to separate companies it was inevitable real competition would begin to emerge.

The Regulator has taken specific steps to encourage and protect on-track competition. For each major flow, the dominant TOC is designated as the “lead” operator, which must offer and accept only inter-available fares. Other operators can accept these interavailable fares, receiving a share of revenues proportional to the passengers they carry. Competing operators can also offer specific non-interavailable fares. Thus a secondary operator can capture a share of the business without the requirement to operate a full, regular service.

At the same time, the Regulator has applied rules to “moderate” competition, at least until 2002. Without some protection against unlimited new entry, it was thought that it would be difficult to sell the franchises. Although the mechanics are somewhat complex, new entry is generally restricted up to a cap of 20% of flows, weighted by value, for each franchise.

Quite a few franchises already face competition on flows reflecting more than 20% of their revenue, and on these routes there is only limited protection against further competition. Gatwick Express, Anglia, Thameslink, Cross Country, and Thames are some of the operators facing red-blooded on-track competition, on a significant share of flows. Others such as LTS Rail and Great Eastern compete on significant flows from nearby stations, for example at Southend, although they do not share the same tracks. In the sale of the franchises the Regulator made it clear he would not look favourably on substantial reduction in on-track competition, through common ownership of franchises. This had the effect of narrowing the eligible bidders for each franchises.

For example, once LTS Rail was awarded to Prism, this company could no longer be shortlisted for Great Eastern. Award of Great Western to an MBO backed by First Bus precluded that company from bidding for Thames, although it was shortlisted for the adjacent Chiltern franchise. Award of both Cross Country and West Coast to Virgin Group has reduced on-track competition on some routes in the Midlands and Northwest, however it appears that the Regulator was willing to accept this as a reasonable price to pay for the massive investment Virgin has committed to make on both franchises.

It surprised some that the Regulator had no difficulty with Connex acquiring both South Central and then the adjacent South Eastern. In fact, these two franchises compete on very few flows. Whether the dominant presence of Connex in Kent and Sussex will make it difficult for any new entrant remains to be seen. Thameslink and Gatwick Express both operate in the area, and with completion of the Thameslink 2000 and Channel Tunnel Rail Link schemes there will be additional paths into the area which will be sold separately. Connex may find that it has not bought quite such as protected monopoly as it hoped. Given that the traffic risks faced by South Eastern and South Central must be very similar, one must also ask whether Connex might not have done better with a more diverse portfolio of franchises.

There has been much talk of re-consolidation, with all franchises eventually owned by two or three companies. This seems unlikely. While it is possible that there will be some consolidation of the existing franchises, it is difficult to see how the 25 franchises could be owned by less than six or seven groups without reducing on-track competition to an extent that the Regulator would not accept. The Regulator has recently stated that he will not support further integration, vertical or horizontal, unless he can see “substantial public interest benefits”.

### 3.4 Interlocking Interests

Several of the franchises are owned by consortia with interlocking interests. For example, Eurostar is owned jointly by Virgin and National Express Group (NEG), among others. Virgin in turn owns the West Coast and Cross Country franchises, both of which compete with NEG's Midland, North London and Central franchises as well as with NEG's intercity coach operations. It appears that the Regulator is satisfied that these overlapping interests will not result in reduced competition, although this remains to be seen.

Many franchises are owned by bus companies, which sometimes have strong local presence in the same area. First Bus dominates local services in Essex and Suffolk, and also owns the Great Eastern franchise which serves the same area. Stagecoach operates many bus routes in the same area as its South West Trains franchise. MTL operates the Merseyrail franchise and also is the dominant bus operator in the Merseyside area.

There is much talk among politicians of the benefits of "integrated" transport. The nationalised BR was reluctant to enter into through ticketing arrangements, or to introduce any bus feeder services which might be perceived as competing either with its own railways or with wholly private services. These constraints no longer apply, and several rail franchise operators have introduced bus services to feed passengers onto their trains. Anglia has introduced a coach link from Colchester to Stansted airport that is, at least in theory, in competition with rail. Great North Eastern has introduced a feeder bus from Lincoln to Newark, which, depending upon one's viewpoint, either complements or competes with Central's rail service between these two points.

It may be that ownership of a rail franchise is seen as strengthening the defensive arsenal of a bus operator, against the threat of competition. National Express has come under scrutiny for its ownership both of several rail franchises serving long distance passengers (in particular Midland, Scotrail, and Central) which serve similar flows to its coach businesses.

### 3.5 Barriers to entry: EWS's new Track Access Agreement

Government designed the franchising process so as to retain a long term "carried interest" in the passenger businesses. Thus the long term requirement to subsidise unprofitable routes will be offset by premiums earned on more lucrative services. Similarly, the Regulatory regime for rail freight was designed so Government could capture any large margins from the use of what remains a natural monopoly.

Essentially, the freight operators are meant to offer prices as high as the market can bear. In most cases, this means marginally less than road transport, taking into account adjustments for aspects of service as perceived by the shipper. Railtrack, in turn, negotiates track access on the same basis, earning large margins on some traffic particularly long hauls and heavy bulk loads where road is not an attractive option. Railtrack's margins contribute to its bottom line profits, which are then captured in the Regulator's "single till". Every five years, the Regulator reviews Railtrack's passenger access charges and has the opportunity (which he will presumably take) to reduce them so that Railtrack's long run return is as low as possible, consistent with attracting capital

for investment. OPRAF in turn has a right to review Franchise payments, to adjust for changes in access charges. So the freight operators are, in effect, collecting money for the Government. Negotiated margins from shippers is an ideal, non-distorting substitute for taxes.

The British approach to freight regulation is unusual. In other countries with privatised rail systems, the operators keep any windfalls to themselves, although perhaps paying some to Government in taxes. EW&S, who purchased most of the BR freight companies, would very much like to change the rules so that they could keep more of their money. They would also, at the same time, like to strengthen their defences against competitors. EW&S have expressed their preference for vertically integrated freight railways, conveniently ignoring the need to share track with passenger trains,

Of course EW&S could not ask directly to be given, in effect, a lucrative monopoly position. Instead, EW&S have argued that the need to negotiate freight rates with Railtrack for each flow is cumbersome, and limits its ability to compete with road transport. Instead of negotiated contracts for each flow, EW&S has offered to pay a standard tariff for each train, plus a fixed charge which would be negotiated on a periodic basis. EW&S could then sell new capacity without needing to negotiate rates with Railtrack.

EW&S's proposals are seductive, not least because very few people even within Railtrack seem to understand the regulatory framework within which the industry operates. EW&S's argument is, however, a bit misleading. First, although EW&S will not need to negotiate charges for new services with Railtrack, they will still need to negotiate access within the timetable. It is not at all clear that Railtrack has been slow to quote charges; what is clear is that there will always be a lead time of weeks if not months in timetabling trains. So the claim that this will make it easier for EW&S to respond to customers seems questionable.

Second, EW&S are not offering to quote a standard tariff to shippers: EW&S will still charge what it thinks the customer can bear, but it will not pass on any large margins to Railtrack at least between periodic reviews. There is no clear mechanism by which Railtrack will adjust the "fixed" charge, short of auditing EW&S's books and establishing in effect a regulated rate of return. Of course, any margin captured by Railtrack is, in turn, captured by the Regulator and passed to Government. While the mechanism as it stands seems perfect, Railtrack only have an incentive to act as "tax collector" because it keeps any excess margins between its own quinquennial reviews. If its contract with EW&S means there are no margins between these reviews, then Railtrack has no interest in the deal which is done.

Third, the proposed Railtrack-EW&S access deal is likely to be a material barrier to entry. Only EW&S has a portfolio of freight flows with which to do this sort of deal. It will allow EW&S, on the margin, to win business at a lower price than a competitor. And once EW&S wins a flow, it will be hard for competitors to win it away.

#### 4. Conclusions

The new rail industry structure is three years old, although most companies have only been in private ownership for less than one year. There has been some vertical “integration”, with two companies attempting to own both rolling stock and franchises. However the other two ROSCOs are firmly owned by groups without interests in franchising. Railtrack is widely held on the Stock Exchange.

There has been some re-consolidation of the operating companies, EW&S dominates rail freight but not yet to an extent that threatens the viability of other players. There was lively competition for passenger franchises, with eleven distinct groups active in the industry where a few years ago there were none. Although there have been rumours of takeovers or mergers between the franchise operators, there is no evidence that any consolidation is actually underway.

With healthy, dynamic competition emerging the new rail industry is off to a good start.

#### The Author

Michael Schabas is a founder Director (non-executive) of GB Railways Group Plc, a newly formed company which was awarded the Anglia Railways franchise in late 1996. GB Railways has subsequently acquired interests in passenger rail businesses in Australia. Mr Schabas holds a Master’s degree in City & Regional Planning from Harvard University’s JF Kennedy School of Government. He came to London in 1988 for the Canary Wharf project. As an independent consultant, he has advised a wide range of public and private clients on matters relating to passenger railways, mostly in southern England.