FIRST ECONOMICS

An Alternative to Franchising

Owner Group Forum, Discussion Paper

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1. Introduction

This quarter's discussion paper is a contribution from First Economics to the debate about franchising. It puts forward a model in which train services are provided to members of the public by fully privatised train companies rather than by operators acting under contract to the government. We see this not just as a viable option in certain parts of the country, but as the natural and socially optimal way of delivering the sorts of services that a number of train operators currently provide.

The paper is structured into three main parts:

- section 2 sketches out the key features of our model;
- section 3 gives a more detailed Q&A; and
- section 4 considers the implications for passengers, operators and government in turn.

2. Summary Description

Our proposition starts from the premise that a government-let franchise is first and foremost a public service contract for a product that cannot be provided to the market on a commercial basis. Where there is a general economic or social interest in train services of this character being supplied to passengers, it seems to us that it is right that the government should step in and secure those services though the award of a subsidised contract. Where, though, the services that a train operator is providing are predominantly profitable in nature, the justification for organising those services via a public-private partnership is much less clear. In other parts of the economy, we see services with wider economic and social benefits being provided by the private sector without the need for direct government intervention and we think that there is every reason to believe that train services would thrive in a similar environment.

Our proposed model therefore borrows heavily from structures that we see in the markets for energy, postal, telecommunications, water and other transportation services within the UK. It comprises the following key features.

Fully privatised train operators

The basic premise is that in parts of the country where passenger train services generate revenue that more than covers their costs, the providers of those services should be fully privatised, fully independent train companies. This would mean that these companies operate without a franchise and without paying (or receiving) monies to (or from) the government.

Because services are not currently organised in this way, the government would need to effect a transition to this new model. This would take the form of a once-and-for-all privatisation of the assets that until now would have been given to a franchisee at the start of its contract.

Economic regulation

With the scrapping of franchise agreements, ORR's role would expand to include the economic regulation of privatised train companies. As in other sectors, regulation would be targeted at areas of market failure and, in particular, segments of the market in which a train company enjoys a position of significant market power and/or segments of the market where a commercial operator might not necessarily take account of the social benefits associated with service provision.

Relationship with government

In the absence of a direct contractual relationship between government and train company, the government step back from service specification and day-to-day enforcement. It would, though, retain its position as an important industry stakeholder and could continue to bring its policies and strategies for the railway to bear on train companies through the ORR-led regulatory process.

3. Questions and Answers

3.1 Overall design and process

a) Which of the existing franchises might this new model be applied to?

The proposition is that all franchises that are capable of operating profitably should be considered for privatisation. We would include in the assessment of profitability the payment of a fully cost-reflective fixed charge payable to Network Rail.

The franchise that most obviously passes this test of commercial viability is Intercity East Coast. However, we can envisage that around half of all franchises might be considered candidates for privatisation immediately or within a period of five years.

b) What is being privatised in our model?

The ‘asset’ being privatised comprises the existing operator’s staff, its rolling stock contracts and its track access contracts. Taken together these are the three main things that permit a train operator to run a service and earn an income.

c) When would/could a privatisation take place?

We envisage that the switch to our model would take place at the end of a franchise term. Rather than hold a competition for a replacement franchise at this point, there would be a competition instead for the right to take over the activities of the train company on a permanent basis.

d) What form would privatisation take?

There are a range of options to consider, but our assumption is that privatisation would be via a trade sale rather than a public offering of shares.

The government as seller would solicit bids and would be able to take into account considerations over and above price – such as track record and the size of the equity commitment – when selecting owners. Payment could be a one-off lump-sum upfront or a series of payments conditional on subsequent performance.

e) Who would be interested in such sales?

We would expect that this model will appeal to a wider group of owners and equity investors than the current model. Experience in other sectors suggest that consortia could be expected to emerge which would combine organisations with operational/railway expertise, including but not limited to the existing owner groups, and financial players like infrastructure funds and pension funds.

f) How much might each privatisation raise?

The value of a privatised company would lay in the discounted value of future profits. These profits would be determined by the difference between annual farebox revenue and annual costs, including staff costs, rolling stock leasing/purchase costs and track access charges.

At one end of the spectrum, the maths for the services provided by Intercity East Coast indicates that a privatisation could be expected to generate billions of pounds. Less profitable companies would go for smaller, but still sizeable amounts.

The government as seller can also adjust expected proceeds up and down through certain policy interventions. For example, a commitment to pay a proportion of Network Rail's fixed charges as capital grants would increase the value of a privatised company. Conversely, capping fares below their current level for a period of time would reduce proceeds.

3.2 ORR as economic regulator

g) Why is economic regulation necessary?

Economic regulation is appropriate in industries where the market alone cannot be relied upon to deliver high-quality services to customers at efficient prices. In the case of passenger train services, two types of market failure are sometimes apparent:

- in some, but not all, market segments it may be that a train operator faces little competition and so enjoys significant market power. This gives rise to the possibility that a company could abuse a position of dominance to the detriment of passengers; and
- it is also likely that with a globally profitable franchise there are certain services that are not individually profitable. If these services have social or wider economic value, it would be detrimental to the wider public interest for those services to be discontinued.

In each of these situations, ORR as economic regulator would have a mandate to step in and protect the interests of passengers.

h) How would ORR regulate?

The main tools that are available to ORR at present are its licensing powers under the Railways Act 1993 and its competition law powers under the Competition Act 1998 and the Enterprise Act 2002. These look to us to be sufficient to deal with the issues we have identified.

It would be for ORR to decide exactly how best to use these powers, but we would expect, based on experience in other sectors, that ORR would rely mainly on the setting and enforcement of licence conditions to discipline train company behaviour.

i) How wide would economic regulation reach?

We consider it vital that regulation is proportionate and targeted only at specific instances of market failure. It should not be unduly intense or burdensome, nor should it simply replicate the prescription that is apparent in current franchise agreements.

This ought to mean that the intensity of economic regulation varies from train company to train company according to the extent of their market power and the degree of cross-subsidy between profitable and unprofitable services within the service mix.

j) How in practice would ORR deal with market power?

In market segments where a train company is dominant there is a good chance that ORR would want to set price caps. It may also seek to impose obligations and/or incentives around service quality. In market segments where a train company's market power is weaker it could be that ORR would be content with lighter touch measures.

We would expect ORR to decide on an initial approach for each train company prior to privatisation, so that passengers, government and owners have visibility of price caps and other restrictions/ obligations prior to the transfer. We would then expect ORR to keep its approach to regulation under review and be prepared to increase or reduce its interventions as market conditions change.

k) How in practice would ORR deal with unprofitable but socially valuable services?

Companies in a number of other regulated sectors have universal or minimum service obligations written into their licences. These licence conditions have been shown over time to offer good protection to vulnerable customer groups and we would expect that ORR would want to build on this experience. This could, for example, mean that ORR prohibits decrements to certain services without its consent.

3.3 Relationship with government

l) Would the government still be able to have a railway policy after privatisation?

It is quite natural that the government would want to retain a keen interest in passenger train services even after privatisation, just as it retains a keen interest in the workings of the communications, energy and water industries. The difference is that the government would channel its policies and objectives through ORR as economic regulator rather than impose very detailed obligations on train companies directly. It is worth noting in this regard that ORR has a statutory duty when exercising regulatory functions to have regard to have regard to strategies and guidance issued by the Secretary of State for Transport and Ministers in the devolved regions.

m) Would there still be clause 18.1 indemnity against changes in access charges?

No. Train operators would be exposed to the risk of Network Rail's charges moving up and down at each periodic review. We would expect ORR to take account of this in its setting of those charges. We would also expect ORR to factor changes in access charges in any price caps it imposes on train companies.

n) Would the government still need to act as the operator last resort?

We think it would be better if legislation was brought forward to bring privatised train operators within the scope of the special administration arrangements that apply to other privatised companies. These arrangements give an administrator a duty to prioritise continuity of service during an administration and ought to mean that trains continue to run as normal in the event that a company becomes insolvent. Importantly, the costs of administration would fall on shareholders and lenders and not the taxpayer.

3.4 Other

o) What access rights would a privatised train company have?

This is the aspect of our model that will require greatest thought. We consider it essential that a privatised company has a degree of long-term certainty about its ability to run a core train service

(NB: if this is not the case, one might as well stick with a model of time-limited franchises). This will require ORR to revamp capacity allocation rules in such a way as to give privatised companies confidence that core access rights will be renewed each time they expire.

No such certainty need be given about non-core services or the allocation of spare/new capacity so as to keep the door ajar to open access operators.

p) Will privatisation inhibit other sorts of structural change within the industry?

It is not obvious why it should. Privatisation of train companies would in no way prevent government from restructuring Network Rail or from moving certain of its responsibilities into train companies, for example. Indeed, privatisation might help to bring about reforms that could not emerge from the current structure; for instance, we can imagine that the rolling stock market will look very different when train companies are in a position to own as well as lease new trains.

q) What will happen to unprofitable train companies under our proposals?

They would be kept within a system of franchising as at present. This seems to us to be the best way of securing services that are not commercially viable even if profitable train companies move to a new structure.

r) Would privatisation mean an end to cooperation and coordination among companies?

No. If necessary, ORR could impose licence conditions requiring companies to participate in cross-industry ticketing, passenger information and similar arrangements.

4. Benefits

4.1 Benefits for passengers

We think that our model offers the following benefits to passengers:

- greater innovation – there has been a recognition in recent months that train operators should have greater flexibility, greater commercial freedom and greater room to innovate. Our model arguably achieves these goals better than any conceivable modification to the current system of franchising insofar as it frees train companies completely from time-limited ownership and from the control of civil servants and forces them to respond directly to customers' changing needs and aspirations. This ought to mean that customers enjoy the benefits of lower industry costs, higher levels of investment and higher service quality;

- companies with a long-term stake in the industry – unlike at present, train companies will not be able to walk away when the market proves tougher than expected. Having made a significant equity outlay at the point of privatisation they will instead be much more likely and much more able to battle through difficult years, re-optimising their business models as they do so and putting them in a position to take advantage of the good years that inevitably follow; and

- regulation in the interests of passengers – this does not mean that they will be exploiting customers. Having ORR as regulator ensures that train companies to do not abuse their positions and should help to prevent systematic under-performance. In fact, passengers might well find that a system of economic regulation, in which it is ORR's objective to protect and promote the interests of customers, is better for them than a government-managed system of franchising which at times can elevate the interests of taxpayers above the interests of the paying passenger.

4.2 Benefits for government

We think that our model offers the following benefits to government:

- sale proceeds – one very obvious attraction of our proposal to government will be the prospect of substantial sale proceeds during a period of fiscal tightening. Privatisation, in effect, enables the government to capture in one go franchise payments that would otherwise come in only over a period of many years. It may well also find that owners value fully privatised train companies more highly than franchisees (because of the benefits they can reap from their greater commercial freedom and from the elimination of distortions to behaviour caused by time-limited franchises), thereby producing a net long-term gain for the taxpayer in addition to the timing benefit;

- greater budgetary certainty – with fully privatisted franchises the government would no longer have to worry about the deliverability of promised franchise payments, including the risk of having to provide revenue support to underperforming franchises and the risk of outright franchise failure; and

- pressure on Network Rail – a very important indirect benefit of the privatisation of train companies would be the greater pressure that Network Rail comes under from its customers. Without finite franchise terms and clause 18.1 protections, train companies will find that Network Rail's delivery and its efficiency has a much greater impact on train company profitability than at present. This countervailing buyer power should help to offset some of Network Rail's monopoly power, leading ultimately to a lower cost of supporting Network Rail for government.

4.3 Benefits for owning groups

Our proposal is not designed with the interests of owner groups in mind. However, we think that train companies will find the commercial freedom that we alluded to earlier attractive insofar as the ability to adapt and enhance their services as customers tastes change gives them the opportunity to add value to their businesses through good management and stewardship. We can envisage, in particular, that companies will benefit from:

- purposive regulation – privatisation takes away the unnecessary prescription and detailed specification that has characterised recent franchise agreements and replaces it with a much more flexible system of economic regulation built around principles and overall obligations;

- longer pay-back periods – having what is essentially a permanent franchise will instantly change the business cases for ideas and investments which are currently made unviable by finite franchise terms; and

- distance from government – privatisation would break many of the strings that bind government into railway outcomes and take away some of the political risk that currently exists within the sector.

We believe that these three things will give good companies the opportunity to earn higher returns than are available under the existing regime (at the same time as their passengers enjoy lower prices and better service quality). If we are right, this ought to be reflected in the proceeds that the government earns through privatisation

5. Conclusion

The description that we set out above is obviously only a very high-level introduction to an alternative way of organising passenger train services. We certainly do not underestimate the amount of work that would be needed to fill in the detail and so ensure that our proposals deliver the best possible deal for passengers and taxpayers.

That said, we do genuinely believe that what we are suggesting ought to be a win-win for both sets of stakeholder. At a time when the government is actively considering its future approach to franchising, we commend this model to all interested parties and hope that it might be given further consideration during the months ahead.