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A review of passenger rail franchising in Britain: 1996/1997–2006/2007

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ABSTRACT

This paper reviews 10 years of passenger rail franchising in Great Britain and highlights problems in three areas: the tension between commercial and social objectives; the presence of risks and uncertainty; and vulnerability to strategic behaviour such as low-balling, chiselling and back loading. It concludes that franchising has had some good features (such as the high level of competitive pressure) but also some bad features (such as a high rate of franchise failures). In addition, an ugly feature of franchising is the scope for strategic behaviour. Further reform is suggested based on a distinction between commercial and social franchises.

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1. Introduction

Great Britain has now had over 10 years' experience of franchising passenger rail services. This has consisted of at least three broad phases. The first phase was associated with the Office of Passenger Rail Franchising (OPRAF). This saw the initial franchising of the passenger rail system in 1996/1997 as 25 separate Train Operating Companies (TOCs). These franchises were tightly prescribed and tended to be relatively short in duration (typically seven years). The second phase, associated with the Strategic Rail Authority (SRA) that was formally established by the 2000 Transport Act (and abolished by the 2005 Railways Act), attempted to move to longer, less prescriptive franchises. In the end only two such franchises were awarded (Chiltern in 2002 (20 years) and Merseyrail in 2004 (25 years)), with the SRA overseeing a further six TOCs being re-franchised using something similar to original template. The third, and current, phase, associated with the Department for Transport's Rail Group has continued with prescriptive and relatively short contracts – albeit with some provisions for extensions, with some 10 TOCs having been re-franchised.

This paper draws on evidence presented to the House of Commons Transport Committee's inquiry into passenger rail franchising (HC1354, 2006), to which the author was an adviser. It also draws on an on-going (at the time of writing) National Audit Office investigation. In so doing, it attempts to answer the question repeatedly posed by transport journalist (and privatisation sceptic) Christian Wolmar – what is a rail franchise for? (Wolmar, 2005, p. 274).

The aim of this paper is not to give a detailed history of franchising in Britain – this is done in detail by the author and others elsewhere (Knowles, 2004; Nash & Smith, 2006; Preston, 2001). Instead, the focus is on some of the key issues that have emerged. The first is the objectives of franchising and the ability of franchising to meet these objectives and these are discussed in Section 2. The second is the impact of risks and uncertainty on franchising, discussed in Section 3. The third is the scope for strategic behaviour and how it may be limited, discussed in Section 4. In Section 5, this paper attempts to draw lessons from the British experience in terms of issues such as the nature of contracts (in terms of length, size and specification), the bidding quantum, the role of transaction costs and the role of horizontal and vertical integration. Finally, it is argued that further refinements are needed if franchising is to meet both the commercial and social objectives of passenger railways.

One issue that should be dealt with at the outset is that franchising has coincided with a period of sustained growth in the demand for passenger rail services. For example, between 1995/1996 and 2005/2006 has seen an increase in passenger kilometres of 44%. Strong growth continued in 2006/2007, with year on year growth of passenger kilometres of 7.6% (ORR, 2007a). However, much of this increased growth is likely to be due to rising incomes. The most detailed analysis on this issue to date is that of Wardman (2005) who estimated that between 1990 and 1998 London rail demand grew by 61%, of which 12% might be attributed to a franchising effect (or the reform package more generally – including fares regulation). Similarly, non-London rail demand grew by 31%, of which 3% might be attributed to franchising and demand in the South East grew by 44%, of which 9% might be attributed to franchising. A similar, but much simpler analysis is shown by Fig. 1. Forecasts of rail demand are based on an income elasticity of −1.2, derived from ATOC (2002). This shows that although demand has

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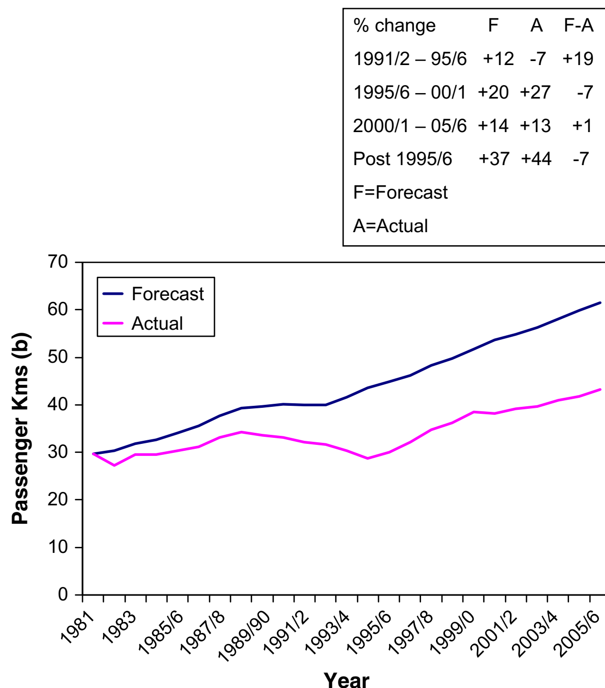

Fig. 1. Forecast and actual passenger kilometres.

grown broadly in line with income based forecasts for much of the period a divergence emerged in the early 1990s which has not been eradicated. Of the 44% growth in passenger kilometres between 1995/1996 and 2005/2006, 37% could be attributed to rising incomes and only 7% (at most) to franchising.

Franchising has led to some service innovations and product development, particularly with respect to ticketing. Initial examples included the development of telephone call centres (see Van de Velde, Mizutani, Preston, & Hulten, 1998), whilst more recent examples include the distribution of tickets by the web and mobile telephony and the provision of WiFi services (Preston & Wall, 2007). This in turn may be expected to have led to some modest market growth (as improved revenue protection) but innovation is not the dominant feature of franchising. The Transport Committee observed that there was ‘very little room for innovation and development’, either at the bidding stage or after the franchise had been awarded.

2. Objectives

One of the original objectives of franchising, which can be traced back at least to Chadwick (1859), is to introduce competition for a market where competition in the market is not possible. This concept was originally envisaged for natural monopolies such as public utilities with the franchise awarded to the firm offering the lowest price to end consumers. Whereas vertically integrated railways may exhibit some natural monopoly characteristics, it has long been recognised that these stem more from the infrastructure than operations (Caves, Christensen, Tretheway, & Windle, 1985). With a vertically separated railway, it is possible that operations exhibit constant returns and the natural monopoly arguments no longer apply.

Open access competition is, however, limited by the lack of profitable opportunities. The Serpell Report (DoT, 1982) had clearly indicated that only a small proportion of rail services in Britain could be operated commercially. The infamous option A involved a reduction in route miles from 10,370 to 1630 (a reduction of almost 85%) and even here, although the railway overall was predicted to make a small profit, passenger services would make a small loss that would be cross-subsidised by freight services (Gourvish, 2002, p. 173). The privatisation of the infrastructure, with the accompanying revaluation of assets and seeking of commercial rates of return, meant that this proportion was likely to be even smaller by the mid 1990s. Given that only a small proportion of the network could sustain competition in the market, it was thus believed that competition in the market was the only way that the disciplines of the market and the private sector could be introduced to passenger rail operations.

However, the original architects of privatisation, such as Foster (1994), always envisaged the franchised, subsidised network being accompanied by open access commercial operations. In the fullness of time these visionaries expected to see the commercial network expand and the franchised network contract as the private sector created more profitable opportunities and the passenger rail market would become configured in a similar manner to the bus and coach industry. This approach neglected an important political risk. A dual market of open access and franchising was believed to limit the competition for franchising and to increase the likely subsidy requirements. The Conservative administration knew it had only a limited time available for franchising and could not afford any slippage to this timetable. The decision was therefore to heavily moderate competition so as to make the franchises effectively exclusive.[1] This was successful in that the whole network was franchised as 25 Train Operating Companies in a period of only 13 months. The policy though becomes less tenable when more profitable opportunities arise – as suggested by the high premia paid by recent successful bidders (see Table 2) and the successful applications for open access by Hull Trains and Grand Central, and further applications from Grand Union and the Wrexham, Shropshire and Marylebone Railway. The argument for franchising then would revolve around the view that any open access competition, being small group, would not necessarily be welfare enhancing and would lead to the high output and high price outcome predicted by models of monopolistic or oligopolistic competition – a view supported by simulation studies in Sweden and the UK (Preston, Whelan, & Wardman, 1999; Preston, Whelan, Nash, & Wardman, 2000). Even if the outcome was close to the perfectly competitive paradigm, capacity at key points (and times) on the network would be limited and would need to be rationed in some form, with market based auctioning probably preferable to regulatory command and control.

If franchising was solely to introduce some form of competition then it has clearly been a success, contrary to the expectations of many at the time, including the author (Preston, 1996). The average number of bids for the first phase of franchises was 5.4, for the initial second phase it was 4.2 (Preston, 2001) and for most recent third phase there have usually been four shortlisted bidders (with the exception of the West Midlands franchise for which there was only two). This gives an average number of bidders of 3.8. There is some indication that the intensity of competition is reducing but this might relate to a more rigorous pre-qualification stage. In any event, competition is not an end in itself but a means to an end. The

[1] In the first phase of the moderation of competition, flows that constituted more than 0.2% of a franchisee’s revenue were protected from competition. In the second phase, which commenced on September 1999, entry is possible on up to 20% of a franchisee’s revenue on registered flows – with the process of registration permitting some strategic game playing. This second phase officially ended in 2002 and was eventually replaced by a regime in which there is no official contractual moderation of competition. However, the current procedures and criteria for granting track access rights preclude services that are ‘primarily abstractive’ which acts as an informal moderation of competition.

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