Privatisation and Franchising of British Train Operations: the decline and derailment of the Great North Eastern Railway

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Abstract

As a result of the 1993 Railways Act, the British railways industry was privatised which resulted in the separation of ownership and control of the railway infrastructure (track, signals and stations) from that of passenger train operations. The Great North Eastern Railway (GNER), a major train operator, was unable to meet its contractual obligations shortly after successfully re-tendering for its second franchise. Within the context of incomplete contract theory, this paper discusses the main problems inherent in the franchising process and which specifically contributed to the collapse of GNER. In particular, the paper argues that the fragmented structure of asset ownership, the lack of coordination and investment incentives and flaws in the franchise method itself explain the demise of GNER and have undermined the general objectives of railway privatisation.

Key words: Railways, privatisation, incomplete contracts, franchises.

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> "…the passenger rail franchising system (is) a self-contradictory muddle, providing no coherent framework or vision for the development of passenger services for future generations. The result is a system that is worth less, and costs more, than the sum of its parts."
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> Passenger Rail Franchising, 14th Report of Session 2005/6, House of Commons, 1534, November 5th 2006, para 15.—

The government set out its proposals for restructuring and privatising the UK's railway industry in a governmental 'White Paper[1]' – which were subsequently enacted into legislation in the Railways Act 1993.

In 1996, the UK government commenced the privatisation process of the UK railway industry. As a result of this process, the government fragmented the former state owned and integrated rail industry into two key segments: firstly, track, signalling and station infrastructure; and secondly, the train operating companies. One of these major train operating companies was the Great North Eastern Railway Ltd (GNER) which mainly operated a prime arterial route from London to Scotland. GNER commenced its first franchised operations in May 1996 and later successfully achieved a renewal of its franchise in 2005.

However, during the period of its first franchise, GNER received a substantial revenue subsidy from the government. In contrast, during GNER's second franchise, the train operator agreed to pay a significant premium to the government. During only the second year of the franchise, GNER ran into major financial difficulties which ultimately resulted in the termination of its franchise. Why did the expected benefits of fragmentation and franchising not materialise? What went wrong? Do the fragmentation of the railway and the incentives provided in the contract explain why the GNER franchise was not viable? What was overlooked by the government and regulators?

The paper aims to address these questions applying incomplete contract theory and therefore, by providing a different perspective of the problem, it extends and complements the analysis resulting from basic financial indicators. We believe that this mixed approach is in itself novel and important for both research and accounting practice because it helps to deepen the understanding of the causes of financial failures. In particular, we discuss how the weaknesses and limitations of the GNER franchise[2] are the result of the lack of coordination and investment incentives in the

[1] See Department of Transport (DoT, 'White Paper'), 'New Opportunities for the Railways', July 1992.

[2] It is not the objective of this paper to suggest how franchised contracts should be stipulated and implemented. This is outside the scope of this paper.

fragmented rail system. We also examine the extent that private self interest deviated from the public interest and the government's position as the rail 'operator of last resort' in order to ensure continuity of public transport. All these issues have undermined the main objectives of the railway privatisation i.e. no substantial improvement passenger services and generous subsidies have not allowed the transfer risk to the private sector.

The paper is organised as follows. Section 1 briefly examines some economic aspects regarding franchises and competition, and then, analyses the problems that might arise in franchise contracts from the perspective of incomplete contract theory. With this framework in mind, section 2 evaluates the franchising method for train operations. Section 3 focuses particularly on the franchise awarded to GNER. Finally, Section 4 draws inferences from the collapse of GNER.

1. Franchises, Competition, Incentives and Incomplete Contracts

Before considering the theoretical framework within which the issues generated by UK rail privatisation can be evaluated, it is important to highlight that "successful utility network privatisation requires incentive based regulation that allows investment to be adequately rewarded from unsubsidised revenues while maintaining quality, and restructuring that permits effective competition for the network service." (Newbery, 2004, abstract)

Network utilities such as electricity, gas and railway are generally regarded as 'natural' monopolies characterised by predominantly substantial sunk investments. These utilities usually deliver essential services to consumers. The traditional conflict between consumers (seeking to pay low prices) and investors (wanting to reap profits) has frequently led to demands for public ownership (access to state investment and control over final prices). But the perceived political problems of keeping consumer prices low, the high cost of service provision, demands for expanding public funding and a lack of investment has led to increased demand for privatisation. In order to avoid transforming public monopolies into private monopolies, privatisation has been frequently accompanied with restructuring to increase competition. A way of achieving this goal has been to separate ownership of the utility infrastructure networks from that of the ownership of the companies providing the network services.

1.1. Franchising and Competition

Conventionally, franchising has often been used to describe different forms of business operations such as licensing distribution and other agency arrangements. For example, in the case of the British railway network, the 1993 Railways Act (sec.6) makes it illegal to operate a railway asset without a licence.

The rail infrastructure company, Network Rail (formerly Railtrack[3]) owns, controls and mantains the rail infrastructure (tracks, signalling, stations[4]) and three private

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[3] On the application of the Secretary of State for Transport, the High Court placed Railtrack plc into Railway Administration in October 2001. The administration process has a number

sector leasing companies (rolling stock companies - ROSCOs) own the rolling stock. The Office of Passanger Rail Franchising[5] (OPRAF), an independent regulatory body created by the 1993 Railways Act, was the inital franchisor and worked closely with the train operators and infrastructure company. OPRAF decided the train paths, set the minium level of passanger service requirement (frequency, duration and departure of the journeys) and invited bids in terms of subsidy (or premiums) that the operators required to provide the service. The train operating companies (TOCs) are the franchisees and initially were allocated franchises for 25 (28 by 2006) specified routes based largely on geographic considerations typically for 7-10 years.. Their major costs are payments for track access charges (TACs) to Network Rail, leasing payments to ROSCOs and their own operating expenditure (labour costs, fuel, etc.).

The concept of separating ownership of the network infrastructure from that of the network operators was indeed to fragment the utility and remove (at least) some of its power by allowing entrants (via competitive tendering) to use the network and to provide improved services for consumers. That is,

> "…contracting out is the element of *ex ante* competition – competition *for* the market as opposed to competition *in* it." (Domberger and Jensen, 1997, p 67).

Early support for the franchising model came from Chadwick (1859), later supported by Demsetz (1968) who believed that franchising was a solution to problems of natural monopolies. In particular, Demsetz believed that competitive bidding for a franchising scheme was useful where it is not possible to rely on potential competition to exert discipline on a 'natural monopolist's pricing.' This situation is likely to arise when there are substantial barriers that impede new firms from entering an industry Dnes (1995).

Traditionally, competitive bidding allows the selection of operators with the lowest estimated service price (after covering costs) at the time of tendering. As the number of potential bidders increases, the benefits of the auction also increase because it puts further pressure on the lowering of prices which facilitates competitive outcomes. Franchising can be viewed as introducing elements of 'market contestability', in the sense that although franchising grants monopoly rights to one supplier, it is temporary in nature, so the supplier could be displaced by another more efficient one that charges lower prices. Ultimately, the contractual sanction for underperformance is franchise termination and competitive bidding provides incentives to achieve production efficiency. It is largely for these reasons that franchises have often been

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of similarities to the Chapter 11 provisions (for companies experiencing solvency difficulties) in the USA. As part of the reconstruction, its parent company, Railtrack Group plc sold Railtrack's plc's infrastructure assets to a specially created 'not for dividend company' called Network Rail Ltd (See Network Rail,2003). This new company started trading on 3rd October 2002. Throughout this paper the infrastructure company will be referred to as Network Rail when appropriate.

[4] In practice, the infrastructure company leased many of the smaller and medium sized railway stations back to the train operating companies.

[5] In 2002, OPRAF was replaced by the Strategic Rail Authority (created under the Transport Act 2000) which was also to determine the allocation of public funding and the strategic direction of the overall railway industry. In 2005, the SRA was abolished and many of its responsibilities for TOC franchises and regulation returned to state control though the Department of Transport.

considered to have an advantage over traditional regulation and nationalisation (See Domberger and Jensen, 1997; Domberger, 1986; Pirie 1988).

Furthermore, Newbery (2004, p.12) emphasised that the benefits from vertical business fragmentation and contracting out would be larger when "…the synergies between network and services are low, and there is excess capacity in service provision, with few economies of scale. In this case it is possible to create a sufficient number of competing service companies while the spare capacity restricts their ability to raise prices above costs if there are low economies of scope between the network and network services."

Besides the above considerations, succesful franchising depends largely on the contract design, monitoring and enforcement. These aspects, that will be discussed next, will influence the behaviour of the contractual parties (Klein, 1995).

1.2. Contractual Difficulties

Train operating companies aim is to be awarded franchises by competitive tendering. Successful tenders will grant the winner the right to maximise profits through rights to use the rail infrastructure in exchange for providing a minimum required service to the passengers with the lowest state subsidy or the highest premium. The franchisor's main aim is to protect the interest of passengers (i.e. guarantee a minimum level of service) and taxpayers. After the contract is struck, the franchisee (i.e. the agent) must make decisions on how to achieve quality service given the rail infrastructure and the available rolling stock (neither of which are under the ownership of the franchisee). The state, acting as the franchisor, (i.e. the principal) has devolved its responsibility to statuary established independent regulators to monitor and enforce the attainment of quality. Franchising can be viewed as a way of sharing risks and lifting the franchisee's resource constraints (Carney and Gedajlovic, 1991; Lafontaine, 1992). But in a world where the agent's efforts are not always verifiable, this typically leads to potential agency problems like 'moral hazard', 'free riding', 'inefficient investment', etc. (Grossman and Hart, 1983).

One way to resolve these potential problems is to formulate a contract specifying all possible decisions and therefore, the principal provides all the incentives to make the agent perform in the way the principal. However, in this 'complete' contract, monitoring and enforcing the contract becomes extremely costly and difficult (if not impossible) in a world of uncertainty and risk which leads to 'incomplete' contracts (see Laffont and Martimort, 2002; Williamson, 1981, 1985). Furthermore, is it possible to devise out a 'complete' contract? That is a contract that (optimally) specifies the rights and responsibilities of all parties in *every* future state of the world and hence, takes into consideration *all* future contingencies and rules out contract renegotiation. Even in the case of no information asymmetry, contracts are incomplete and organisational forms (i.e. boundaries of the parties) are important in determining agent's incentives (Hart 2003).

These 'incomplete contracts'[6] arise because of the impossibility to account, ex-ante, for all unforeseen events. Even if it were possible to account for all contingencies, the cost of identifying all of them in the contract will be excessively costly; the contract will become too complex to be understood; and hence verification and contract enforcement will be impossible. Indeed, a contract "is incomplete if the parties would prefer to add contingent clauses, but are prevented from doing so by the fact that the state of nature cannot be verified (or because states are too expensive to describe *ex ante*)" (Hart and Moore, 1999:134). That is, ultimately, transaction costs prevent writing out complete contracts and open the door for contract renegotiation[7].

In the tradition of 'transaction costs', Williamson (1975) and Klein et al (1978) argue that because of the impossibility of writing a complete contingent contract, the possibility of opportunistic behaviour increases when the two parties in the contract are very different and neither can operate without each other. In this case, the transaction cost approach to vertical integration minimises *ex post bargaining inefficiencies* arising from renegotiations.

The question that follows is who has the upper hand when contracts are renegotiated? The 'property rights' approach emphasises the importance of relation-specific assets and the extent that ownership structure affects the relative bargaining position of the two parties and hence, their relative ex ante incentives[8]. In an environment of incomplete contracts, ownership of an asset is important because it provides residual rights to control *ex-post* contractual outcomes. That is, ownership improves bargaining power and enhances the relative position during renegotiations[9], attenuates the 'hold-up' problems[10] and more importantly, influences agents' incentives (See Hart, Shleifer and Vishny, 1997; Hart, 1995, 2003; Aghion et al, 2006).

In order to illustrate the above points, the principle underlying Hart et al's (1997) example of privatisation of some prisons can be applied to the rail industry. Society (represented by the government) wants public transport to be provided. Assume two

[6] Tirole (1999:743) argues that "…there is unfortunately no clear definition of 'incomplete contracting' in the literature…incomplete contracts are usually preceded by an invocation of transaction costs."

[7] Franchise renegotiations may include extending the franchise term or re-letting a franchise on new terms but also delays (and any amendment) in franchise termination should be considered as 'implicit' renegotiation.

[8] It is important to note that according to 'transaction costs', vertical integration provides positive investment incentives for both parties; while in the case of 'property rights', the party who owns the asset has an incentive to invest at the expense of the other party. See Aghion et al (2006).

[9] This might not hold when parties share responsibilities in public (i.e. non rival and non excludable) good provisions. Besley and Ghatak (2001) argued that although party A owns the project, its bargaining advantage is reduced because it cares about the outcome of the project and it cannot finish the project on its own. Therefore, party A will be willing to transfer resources to party B and this has positive ex-ante investment incentives for party B. .

[10] Hold-ups problems among contractual parties happen when the parties share the surplus arising from their interaction and when one party making an investment does not receive the full benefit that should receive from such investment.

scenarios[11]: a) the government owns the rail system and employs a manager to run it. b) The rail system is privately owned and the government contracts out the provision of public transport.

'Innovations' by the manager can take the form of quality innovation to improve the rail service or cost cutting which has an adverse effect on quality of the service but staying within the boundaries of the contract. Quality of the service is assumed difficult to identify, to measure and specify prior to the delivery of the service. These 'innovations' are *not contractible ex ante* and require 'authorisation'. If the government owns the rail system, there is little incentive for the manager to 'innovate' because the government might 'hold him up' and give him a small share of the additional gains. In contrast, ownership by the private contractor promotes quality innovation but this will not be introduced unless a new contract is written and the government (buyer of the service) agrees to pay a higher price for the improvement. If so, the private contractor has to share the gains from quality improvement, and this decreases its incentive to improve quality. Cost cutting requires no government approval so the government has to bear the cost of quality deterioration. Therefore, the private contractor has more incentives to 'innovate' than the manager employed by the government. "But, the private contractor's incentive to engage in cost reduction is typically *too* strong since it ignores the adverse impact on quality" (Hart et al 1997:1129).

Although performance bonds and termination clauses allow the franchisor to control opportunism on the part of the franchisees, it is not then possible to verify and monitor in detail the quality of the service. Each TOC leases its rolling stock and pays (fixed and variable charges) for the use of the rail infrastructure. Nonetheless these are largely fixed costs. Given that the level of subsidies received or premiums paid is explicitly set in the contract, the TOC has a strong incentive to innovate via cost cutting (rather than quality improvement) to increase profits. According to Shaoul (2005), the main variable costs are wages and light maintenance of trains. She agues that some TOCs have made substantial reductions in maintenance costs (cheaper suppliers, reduction in skilled staff, etc) with negative effects on the standard and reliability of the services. That is, incomplete contracts cannot only lead to 'ex post' opportunism; but also to 'ex ante' opportunism given that the franchises are normally awarded on the basis of the lowest subsidy (or highest premium) and the level of subsidy (or premium) is largely determined by the bidder.

The choice between government and private ownership imposes trade-offs. In contrast to government ownership, private ownership increases the possibility of 'quality-shading' investment but it provides stronger investment incentives.

These issues become more complex when we consider issues related to transfer of ownership, size of the investment, quality of service and enforcement of contracts. For example, if the size of the investment is large and ownership of assets lies with

[11] The time line is as follows: at time 0, the government and the manager choose an ownership structure and write a contract; at time 1, the manger can invest or cut costs; at time 2, service supplied if no renegotiation or renegotiation given 'innovations' and realisation of ex ante uncertain state of the world. Also note that 'ownership' can also mean 'right to use' therefore, the example applies to franchise.

the private sector, then the contract might have to be 'lengthy' (in terms of time) to make it profitable. But long-term contracts might restrict competition and make contracts less enforceable if breach of contract requires buy-back of the assets. Indeed, Veljanousk (1989) argued that franchising is less likely to be desirable when large capital investment has to be made since the duration of the franchises will have to be lengthy (e.g. 15 to 20 years) and weaken the impetus for competitive re-tendering.

A related concern is the one of regulation. From the agency perspective, Beales and Muris (1998) discuss how regulation might protect franchisees and franchisors from opportunistic behaviour and the problems that regulators encounter when identifying the 'real' reason for hold-ups or contract termination. As highlighted by Newbery (2006), regulation becomes more important in the case of natural monopoly network utilities where private investors will not invest if they do not have an assurance that they can charge sufficiently high prices. Note that these firms offer essential services required by all the population so price capping is one way to regulate private ownership and maintain competition under the presence of market power. However, unnecessary regulation and overregulation is not desirable because regulation may be correlated to pressures from interest groups to redistribute rents rather than looking after the welfare of the consumers. Yvrande-Billon and Menard (2005:678) warned of the dangers of imposing a mode of organisation on an industry by a regulator "with no or very little consideration for the transactions at stake". They noted that 'organisational mis-alignment' can develop, not because of wrong choices made by companies but because exogenous choices are imposed on them that they can hardly change. Furthermore, misalignments can also happen when an arrangement in which the characteristics of the mode of organisation adopted do not fit the attributes of the transaction it has to organise. Indeed, Joskow (2002) believes that this misalignment typically occurs when the 'unbundling' of former public utilities have not taken account of the characteristics of transactions between parties.

2. Franchising of Train Operations

A key part of the Railways Act 1993 was the franchising of train services. The UK government (DoT 92, para 21) was convinced that train service franchising would bring about "greater responsiveness to passenger needs, improved efficiency and better services…(and eventually the franchisees would)…make payments to the government."

The government developed the train operators franchising scheme from earlier proposals by Irvine (1987) who believed franchising would bring competition into the market by the creation of 'competitive tensions' that would evolve from the contractual relationships of the train operators. Irvine argued that this resulting 'competitive tensions' would lead to more efficient operations and greater market responsiveness. Murray (2005) also believed that the introduction of 'competitive tensions' would lead to a superior privatisation method than the earlier privatisations of utilities. Many utilities were initially privatised as large monolithic suppliers that often failed to deliver a fully responsive market. In the long run, the government believed that state subsidies would be eliminated "…as franchises running profitable services would make payments to the government." (See Jupe 2007: 83.) But critics of the government's rail privatisation model came from Wolmar (2001, 2005) and

Terry (2001). Both argued that the UK rail privatisation process was financially wasteful, poorly conceived in organisation and was soon considered to be failing. Similarly, Crompton and Jupe (2006, 2003:397) strongly argued that the privatisation process was

> "[F]undamentally flawed' because it produced an inefficient system with higher costs, poor quality of service and increased public subsidy."

In particular, Jupe (2005, 2007) showed that one of the major weaknesses in the franchising system was the track access charges. These charges formed the key contractual inter-face link between the train operators and Network Rail and were the key basis of the franchise contract[12]. In practice, difficulties such as infrastructure malfunctions by Network Rail gave rise to a complex and often contentious contractual compensation framework between the infrastructure provider and train operator. Did malfunctions happen mainly because Network Rail underinvested or mainly because the TOCs were using very heavy/old rolling stock and hence placing too much pressure on the rails? In any case, malfunctions might be the consequences of underinvestment, strategic behaviour and quality 'shading' arising from the franchise.

Overall, Jupe (2005:190) concluded that the:

> "franchise system in practice has not transferred substantial risks to the private sector or ensured as tight a control over costs as [the former state owned] British Rail achieved."

Preston et al (2000:99) conducted in-depth interviews with 38 potential bidders of train service franchises. They found that:

> "…by far and away the most widely reported difficulty facing potential franchisees was gaining an in-depth understanding of the franchise and gaining an understanding of the structural and regulatory regime that surrounds it."

Criticism of train franchising also originated from the Strategic Rail Authority (SRA), a state regulator specifically created to award and supervise train services. In 2001, soon after its formation, the SRA (2001:28) initially claimed that its responsibility for franchising would "provide a framework for delivery of the government's '10 year Transport Plan[13]'" and the SRA's priorities would be to deliver "more punctual and less crowded trains" and it would develop "more resilient rail operations." But within two years, the tone of the regulator's opinions had substantially changed. The chief executive of the SRA, Richard Bowker (SRA 2003/4: 6) subsequently highlighted the incomplete nature of the franchise agreements when he indicated that the franchised TOC model was "proving increasingly unworkable". In particular, Bowker indicated that the terms of the franchises must be made clearer "about precisely what the TOCs are required to deliver." Bowker (SRA 2003:13), referring to the earlier railway disruption caused by the Hatfield rail crash, believed that the franchising model has "…proved unable to withstand the exogenous market shocks experienced in the last

[12] Shaoul (2006) noted that 'about 75% of the TOCs' revenues went on 'external' purchases, mainly on TACs.

[13] In 2000, the UK government issued its plans for transport development in the UK for the following ten years (DETR 2000).

few years" such as the disruption to train services caused by the Hatfield train accident which resulted from poor maintenance of the track.

As a result, the SRA (2003/4: 20) attempted to initiate "significant changes to the way it managed franchise contracts, embedding a forward looking business plan and risk based approach to ensuring delivery of franchise obligations". In effect, these changes led to greater SRA control of the franchise specification of overall train operations and service levels. The SRA (2004/5: 27) believed that the most significant development of this change was in the way the "…TOCs approached the planning and delivery of their rail services." However the SRA provided no feedback on how its 'more involved approach' to franchise management was working in subsequent years.

In addition to criticism from the state regulator, the government itself was becoming increasingly concerned that franchising was not delivering the benefits it had initially expected. In particular, the government's own ten-year Transport Plan for the country, (DETR, 2000) was critical of the limited benefits seemingly provided by the franchised TOC model. According to the Transport Plan, the major flaw of franchising was that long term planning and investment was inhibited largely because the franchises were often only held for a short 7 year period – which was considered too short to encourage investment in services and routes[14] .Even more pointedly, James Sherwood, president of GNER's parent company Sea Containers Ltd[15] (which successfully tendered for the East Coast Main Line franchise) criticised the fragmented franchising method of train services because "…the cost of operating separate infrastructure and train companies is much higher…than if we had an integrated railway."

But there is a trade-off. Integration of the railway system might be less costly in terms of subsidy but leads to monopoly whilst fragmentation, aimed to increase competition, cost more to the taxpayer given that the government cannot allow the system to collapse. In any case, fragmentation and franchising has resulted in little competition. As stated earlier, one company owns the rail infrastructure, three companies own the rolling stocks and "just three large transport groups either owing outright or holding more than 48% of shares in the operators of fourteen passenger rail franchises in the UK. The franchising market has also attracted very few entrants in recent years…" (House of Commons Transport Committee, Passenger Rail Franchising, 14th Report of Session 2005/2006:26). Train service competition was hindered because there were significant barriers to entry for new train operators. According to the House of Commons Transport Committee, these barriers were mainly related to a) the cost and complexity of bidding for a franchise and, b) the relatively new emphasis upon past performance in the evaluation of bids – which they believed was a handicap to companies that had not previously managed rail franchises.

The Department for Transport (2004 White Paper) identified serious weaknesses in the key contractual inter-face relationship between the TOCs and Network Rail, the

[14] See also Terry (2001)
[15] Reported in the *Guardian* newspaper, 'Head of GNER calls for track and train integration,' 25 November 2004, p21.

infrastructure provider. In particular, DfT considered that the track charges (paid by the train operators) had "…little relation to the costs the companies impose on Network Rail." The effects of this distorted market were highlighted by the same House of Commons' report, which concluded that there was:

> "…little evidence that competition has produced significant increases in innovation or improved the value for money for taxpayers and passengers…[and]…there is also little evidence that risk has been transferred from the public to the private sector." (p.47) and '…[T]he reason for the lack of risk transfer is primarily because, at the end of the day, no Government can afford to let part of the railway system collapse. As a result, the Government and the taxpayer pay for a large part of the risk in the system." (p.8)

This government attitude of 'operator of last resort' and the fact that TOCs do not need any substantial investment to operate the service explains why TOCs' bids were as claimed by Shaoul (2006, 2005), to be 'hopelessly optimistic'. Indeed, the House of Transport Committee also alleged that some operators were entering into very high premium contracts on the basis of very optimistic growth forecasts. The SRA had to increase subsidies over what was contractually agreed in the original franchise agreement (see SRA Strategic Plan 2003). For example, Connex South East (operated services from London to the south coast) had its franchise forfeited back to the SRA[16] because of persistent poor quality of service performance. However, Connex received additional subsidies of £58m in 2002 from the SRA because, in the words of the Transport Select Committee (2004:145), 'they had got their numbers wrong'. By 2003, over a third of all the franchises had breeched the terms of their franchise and they were placed on a SRA management contract[17].

In the case of TACs, the Committee highlighted that the Government protected franchisees against increases in Network Rail's track access charges for using the infrastructure "…by adjusting premiums or subsidies to take account of any changes in access charges." In effect, the TOCs were protected against any increases in the TACs permitted by the ORR and imposed by Network Rail. For example, in 2003, the ORR revised the TACs for 2004/9 by a 50% increase on ORR's earlier levels set in 2000. Since the TOCs were protected against this increase, the state had to increase TOCs' subsidies – resulting in the SRA scaling back the TOCs' investment plans (SRA, 2003; Murray 2002).

Note that problems arose not only because of TOC 'protection' but also because of weak contractual enforcement. In particular, the National Audit Office[18] (1996,

[16] If a train company fails persistently to meet performance criteria under Section 30 of Transport Act 2000 the SRA can reacquire the franchise and directly operate train services as the operator of last resort. (See SRA Annual Report, 2003/4 p53.).

[17] This was a 'cost plus' agreement whereby the SRA took all fare revenue from a franchise but reimbursed the costs of the franchisee plus a 'profit' for the franchisee between 1%-2% of revenue (see also SRA, 2003: 47).

[18] The National Audit Office is independent of government and reports directly to Parliament. The NAO reports on the accounts of all government departments and a wide range of other public sector bodies. The NAO has statutory authority to report to Parliament on the economy, efficiency and effectiveness of departments and other bodies. [See http://www.nao.org.uk/about/index.htm]

2002) pointed out that the incentive regime that rewards (and penalises) good (and bad) punctuality is selectively applied and was not thought to be very effective.

Overall, the franchising system and the fragmentation of ownership created little competition, introduces moral hazard and failed to provide the investment incentives to the detriment of passenger quality service and to the government exchequer funds. This fragmentation lends support to Bradshaw (1997) who believed that there will be little scope for 'on rail' competition between the TOCs, to Curwen (1997) who claimed that the (franchising) model was complex and expensive to set up and finally, to Nash (1997, 2002) who identified that many franchisees had built their franchise bids around bid reductions in operating costs and doubted whether the aim of reduction in subsidy was sustainable.

3. GNER: A Case Study in Franchise Failure

One of the larger TOCs winning the franchise for the major arterial route along the east coast of England was the Great North Eastern Railway Ltd. GNER had its origins as Inter City East Coast (ICEC) Ltd, incorporated on 9th June 1994 by the state-owned British Railways Board (BRB) in anticipation of later privatisation. Under the 1993 Railways Act, the BRB vested the business assets and liabilities into ICEC Ltd on 1st April 1995[19]. The share capital of InterCity East Coast Ltd was acquired by Great Northern Railway Ltd, (a subsidiary of Sea Containers UK Ltd[20]) from the state on 28 April 1996 and on 22 October 1996, it changed its name to Great North Eastern Railway Ltd (GNER).

The GNER franchise encompassed the operations of train services on the major London to Edinburgh route with other services to major urban conurbations such as Leeds and Newcastle. In being awarded the initial franchise, GNER successfully tendered to operate the service largely based on a subsidy profile.

However, the first franchise's results were distorted as a consequence of a major GNER derailment on the outskirts of London in October 2000. As a result, there were severe financial, operating and political implications not only for GNER but also for the whole UK rail industry. The cause of the accident was largely found to be neglect of the track by the infrastructure owner, Railtrack (and that of its maintenance contractor)[21]. The resulting railway operating restrictions placed upon the TOCs led to major distortion of GNER's (and other TOCs) funding and revenue streams. The resulting legal and financial claims and compensation payments involving Railtrack

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[19] See p2, Directors Report and Accounts, ICEC Ltd 1996.

[20] In turn, Sea Containers UK Ltd was a wholly owned subsidiary of Bermuda based, Sea Containers Ltd.

[21] The resulting operating and funding difficulties of Railtrack in improving the track quality standards of the network led to widespread national rail disruption for train operating companies in general and GNER in particular. The subsequent costs for the railway industry were severe. The train services of many TOCs were massively disrupted while urgent engineering checks were implemented. See Hatfield Derailment Report, ORR, 24 July 2006 ORR/21/06: http://www.rail-reg.gov.uk/server/show/ConWebDoc.8190. As a result of this disruption caused by the Hatfield accident, Shaoul (2006:156) noted that over "…£591m was paid in penalties and compensation to the TOCs for late and cancelled services."

and the SRA were substantial, unanticipated and outside the remit of the franchises' terms. As a result, many of the profiles of subsidy receipts (and premium payments) were revised[22].

A particularly relevant issue is the extent to which the GNER franchise provided incentives to encourage Network Rail[23] (and formerly Railtrack) to undertake quality investment. Since Network Rail sets track charges (taking into account that its return is regulated by the rail regulator), changes in track charges to GNER are ultimately paid by taxpayers through increase subsidies[24]. When innovation/quality is not contractable ex ante, Network Rail lacks incentive to invest because once the investment is made, negotiations over the division of the benefits lead to a sharing of the benefit enhancement made possible by Network Rail investment. Nevertheless, Network Rail has a stronger incentive to cut costs with adverse consequences on quality. Wolmer (2005) argued that Railtrack concentrated in maximising profits and sharing dividends at the expense of investing in assets and safety. He claims that Railtrack had no incentive to ensure that the track could cope with additional traffic and that not only Railtrack did not buy enough rails but "no-one was in charge of the wheel interface" (p. 174)

3.2. Performance

Table 1 shows that during the first year of its private sector status (1996/7) to the last financial year of the first franchise (2004/5), GNER had a declining annual subsidy from £49.82m in 1996/7 to £3.09m in 2001/2. Although the franchise continued three more years, in 2004/5 little or no subsidy (or premium) was received (or paid). The first full length 12 month accounting period, commencing in 1997/8, highlights GNER's annual revenue of £323.68m with an operating profit of £13.25m (after including a £57.77m subsidy.) By 2002/3, revenue has grown by 32.6% reaching £410.45m – with operating profits reaching a peak of £57.88m and with negligible subsidy levels.

Analysing this increase in earnings is difficult because of the on-going legal set-offs after Hatfield and the lack of disaggregated data in the published financial statements. Undoubtedly, over this period GNER benefited from a general increase in national passenger traffic experienced throughout the whole network Besides this, Shaoul (2005) argues that TOCs benefited as well from 'revenue protections' (ensuring passengers paid full tickets for their journeys) and increase in some unregulated fares (e.g. supersavers, unrestricted train tickets) above inflation level. Costs for usage of track access and rolling stock were higher than before privatisation but subsidies where also higher. She claims that "...most of the external costs are largely fixed,

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[22] In the case of some TOCs, the disruption to train services was so acute that the SRA had to step in with financial support to allow some TOCs to continue trading e.g. Central Trains, Greater Anglia, etc. See Wolmar (2005).

[23] Furthermore, the above interpretation might also help to explain why Network Rail was created to acquire Railtrack. Network Rail is a company limited by guarantee, with no shareholders and accountable directly to their members (drawn from the railway industry, the public and the Department of Transport) and regulated by the Office of Rail Regulation.

[24] If the rail regulator allows Network Rail to increase the TACs paid by a TOC after contracts are signed – the government (DfT) will indemnify the TOC.

management sought to contain labour and maintenance costs in order to generate a surplus.” (p.27)

In the final two years of the first franchise, revenue increased by 4.5% in 2003/4 and by another 10.8% in 2004/5. But although revenue increased, corresponding operating profits declined from a peak of £57.88m in 2002/3 to £45.03m in 2003/4 and £19.88m in 2004/5 – an earnings decline of 67% over 2002/3 to 2004/5 period – when virtually no direct subsidies or premiums were involved.

With respect to dividends, over the period of the first franchise, GNER made total distributions to Sea Containers UK Ltd, its parent company of £146.6m, amounting to virtually all of its net earnings over this financial time period.

Extension to First Franchise

Pending the second re-tendering process, the SRA generously granted GNER a 2-year extension to its franchise from April 2003. Although it was initially planned for GNER to pay a premium payment of £25.145m and £70.26m in 2003/4 and 2004/5 these explicit terms were dropped by the government[25]. Instead, GNER agreed to pay for some minor station and infrastructure enhancements, improve both customer compensation and ‘customer satisfaction regimes’ refurbish some passenger rolling stock and increase driver recruitment. It was estimated by the government that these changes would amount to ‘some £100m.’ However there are no published figures to support to what extent, if any, these improvements were implemented. The government did not explain why GNER’s premium payments were substituted by a ‘commitment’ to improve investment in its services. Previously, in GNER’s case, as with other franchised train operators, investment in services was a business and revenue generation an issue for the TOCs themselves (and not related to any franchise agreement to pay premiums or receive subsidies.)

Second Franchise

In March 2005, the SRA (Annual Report and Accounts 2005: 2) signed a new franchised agreement for 7 years from 1st May 2005 with automatic renewal for a further three years subject to meeting ‘certain performance targets.’ The franchise was awarded to GNER after successfully competing with a Virgin Stagecoach consortium, Danish Railways and First Group.[Some press reports stated that GNER had paid more than £300m than its nearest competitor for the franchise but, for reasons of ‘commercial confidentiality’, the DfT has not released the precise figures (see Robinson, 2006).

The second franchise awarded to GNER marks a shift in attitude of the SRA to many of the TOCs. The earlier franchises were often characterised by a large number of TOCs receiving subsidies which proved to be very expensive for government funding[26]. As a result, in the second round of franchisees, the government move to an increased use of premium based franchises. But this was tempered by the

[25] See DfT Press Release dated 16 January 2002 ‘Two year extension agreed - £100m private sector investment committed.’
[26] By 2004 the overall annual subsidy to TOCs had reached £2bn instead of gradually declining to £800m as envisaged at the time of privatisation (Wolmar, 2005).

inclusion of more ‘cap and collar’ contractual arrangements whereby the government would take a share of any losses incurred or profits made – if the a TOC’s financial results fell outside specified levels.

Within this new trend, the key feature of the second franchise was the high level of GNER’s premium payments (see table 2), which implied a substantial and sustained growth in passenger traffic flows needed to generate increased cash flows that were necessary to meet this increased obligation to the government.

Compared with the last year of its first franchise and the first year of its second franchise[27], revenue only increased from £475.4m to £477.7m, growth of only 0.5%. At the same time, the company was required to commence premium payments[28] of £52.7m leading to operating profits falling from £19.88m to £7.24m.

Under its franchise terms, GNER was generously protected from substantial risk to its income stream after the first four years by the disproportionate sharing of risk with the government if revenue is significantly below target. For example, Perren (2005: 30) noted that after 2009, ‘…if revenues are less than 84% of target the deficit is then shared 20% to GNER and 80% to the government but between 94% - 98% it is shared equally’ which creates potential moral hazard problems.

The financial position of GNER reflected poor growth in passenger revenue, the introduction of substantial premium payments and GNER’s parent company extracting considerable reserves from the company in the form of dividends. In particular, from passenger revenues of £427m, GNER reported an operating profit of only £7.2m.

In the previous year, GNER had a passenger revenue stream of £423.5m and an operating profit of £19.9m. In spite of predictions of revenue growth of nearly 10% in its franchise tender, GNER increased revenue only negligibly. In addition, GNER was now required to pay a premium of £33.35m over the full financial year 2006/7. GNER (Annual Accounts 2006:7) was also experiencing falling liquidity levels and the appearance of net current liabilities in the 2006 balance sheet. By 7 January 2006, the last balance sheet produced by GNER before its collapse later in that year, showed the company had very few assets remaining in its balance sheet. Net assets fell from £27.4m in 2005 to £5.45m in 2006 largely as a result of the company extinguishing its previously accumulated revenue reserves by paying a sizeable total distribution of £35.74m back to its parent company.

However, by August 2006 (before GNER had even filed its 2006 financial statements[29]) Sea Containers UK Ltd admitted[30] that ‘GNER has underperformed the financial projections in its franchise plan because fewer passengers are travelling than

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[27] No financial statements were produced in the year of GNER’s collapse i.e. in 2006/7.

[28] Premium payments are included as part of operating expenditure and are not separately disclosed in GNER’s published accounts. (In this case, DfT sources of premium payments are used: see Table 2.)

[29] Under UK legislation, private limited companies with no direct overseas holdings have 10 months after their year-end to file their financial statements which are then assessable by the public. GNER’s accounts were not filed until nearly the end of this ten month period.

[30] See *Daily Telegraph*, London, 12 August 2006.

estimated in the bid.' In a Press Release[31], Sea Containers stated that GNER's passenger revenue was only a third of the growth as forecast[32]. In particular, in GNER's franchise bid, it was optimistically assumed that passenger revenue would amount to £510m which implied a 9.9% increase in revenue (over the fourteen month period May 1 2005 to June 30 2006), compared with the same period in 2004/5. But in practice, passenger revenue was only 3.3% higher.

Explaining GNER's Demise

So seemingly determined were GNER to re-win the franchise that Christopher Garnett, the chief executive who bid for the second franchise (but who resigned from GNER in August 2006) indicated[33] that he "… would rather over-bid and win than under bid and lose." A few months later, Bob MacKenzie, chief executive of Sea Containers was reported[34] as saying that GNER "…could *not* cope with the £1.3bn premium that it had to pay the (UK) Treasury." He rather simplistically indicated that GNER's revenue projections were just too 'optimistic'. In spite of the generous risk sharing agreement incorporated in the revised franchise between GNER and the DfT, the first year results provide sufficiently strong evidence that GNER would be unable to meet future premium obligations.

Within months of the commencement of the second franchise, in September 2006, the former chief executive, Christopher Garnett admitted[35] that "GNER was no longer sustainable…the (profit) margins are too slender...[T]he market will self-destruct, as bidders win on ever-tighter margins."

When GNER ran into financial difficulties, and although the government was formally unwilling to renegotiate the terms of the franchise, the government did so in practice.
Sea Containers had lodged a performance bond[36] with the DfT of £15.3m (which would rise to £28.7m in May 2007) in case GNER was unable to comply with its franchise terms, the DfT agreed to waive this requirement. In December 2006 when Sea Containers decided it could not continue operating the franchise, the DfT, (as the 'operator of last resort') agreed to waive this bond, provided the parent company agreed to 'co-operate' in running the service (on behalf of the government on a 'cost-plus' management contract) until new franchise bidders[37] could be sought (See DfT 2006).

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[31] Press release: 'Sea Containers provides up date on financial condition and on GNER's operating performance', Hamilton, Bermuda, August 11, 2006.
[32] Ford (May 2005) noted that for GNER to achieve its revenue targets, an average load factor of 83% was assumed - a figure that Wolmar (2006) also described as 'very ambitious targets.'
[33] See: Friedli D. (2005), 'Fighting to Stay on Track.' *The Scotsman* newspaper, 27 March.
[34] 'Sea Containers to ditch GNER in May', *Sunday Times Business News* dated 22 October 2006.
[35] On 26 September 2006, *The Times*, London – 'GNER no longer sustainable…'
[36] In addition, it was also a franchise condition that GNER has 'in place a £30m standby credit facility during the term of the franchise, callable by GNER in the need of liquidity.' This standby credit was provided by Sea Containers. GNER was also required to have £10m overdraft facility, guaranteed by Sea Containers to provide additional working capital if needed' (see Sea Containers Ltd news release, 11 August 2006, para 2/3. pp10-11).
[37] See http://www.dft.gov.uk/pgr/rail/passenger/franchises/icecf1/competitioncommences

However, neither Sea Containers nor the government appeared to accept that inherent flaws in the franchising process as being the reason for GNER's collapse. Many of the reasons put forward by Sea Containers for GNER's demise are not fully justified. Rather than highlighting the substantial increase in its premium payments under the renewed franchise as a major source of GNER's difficulties, Sea Containers attempted to justify the financial problems of GNER by blaming 'the disproportionate effect' of falling revenues resulting from the 2005 summer terrorist bombings in London.

Sea Containers claimed that more than half of the passenger revenue losses resulted from passengers not travelling to London as a consequence of 'the focus of terrorist activity around Kings Cross[38] station in London.' In particular, Sea Containers (News Release August 11 2006, see also Railway Magazine 2006) admitted that it had failed to meet its 9.9% increase in passenger loadings and only rose by 3.3% resulting in a £33m loss of revenue. The primary cause was attributed to a loss of passenger traffic as a result of the July 7th 2005 London terrorist bombings which accounted 'for just more than half of the shortfall.'

However, GNER's claim is not explicitly supported by publicly available passenger traffic flows. Although the rail passenger statistics do not identify specific train operators, national travel statistics (ORR, 2006: 13) disclosed that the number of passenger journeys nationally in the UK did fall by 3.3% in the second quarter of the year (that included the London bombings) from 270 million journeys in the first quarter[39] to 261 million journeys. However, in previous years there has normally been a drop between Quarter 1 and Quarter 2. [e.g. In 2004, the equivalent fall was 2.8% and in 2003 it was 2.8%.] Significantly, in the following quarter (after the bombings) national passenger journeys actually increased by 8.8% compared with a comparable increase of 5.4% in 2004 and 4% in 2003.

Ford (2007: 20-21) was particularly critical of the level of GNER's passenger mileage over the existence of both of its franchises. He noted that between 1993/94 and 2005/6, although passenger numbers increased by 70%, total passenger miles increased from 1.895bn miles to 2.566bn miles – an increase of only 33% over 12 years.

Sea Containers also blamed a weakening in the UK's gross domestic product (GDP) and 'improvement in Network Rail's performance' (which implied less compensation payments for delays cause by infrastructure failures.) However, the UK had experienced substantial growth in its GDP[40] growth rate in the previous 12 quarters. Since the second quarter of 2005, the UK's GDP has increased from an annualised 1.6% to reach nearly 3% in the last quarter of 2006 (reaching the highest level since the second quarter in 2004.)

Additionally, the 'unforeseen improvement' in Network Rail's performance should not have come as a surprise to GNER, given that NR had an intensive investment

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[38] London Kings Cross station was the only London terminus railway station for GNER.
[39] Quarter 1 commenced in April; the bombings happened at the start of Quarter 2 in July.
[40] See: http://www.statistics.gov.uk/cci/nugget.asp?id=192

programme since the Hatfield accident highlighted under-investment in its infrastructure. For example, NR's Annual Report (2005:2) claimed that performance has seen "…accelerating improvements in the performance and efficiency of the rail infrastructure….and (that) substantial improvement has been made…[and]…a large number of initiatives have contributed to this notable improvement."

Furthermore, GNER sought to apportion blame for their demise on the threat of more competition. At the start of its second franchise period, GNER became involved in a dispute with the rail regulator about allowing Grand Central Ltd, a recently formed 'open access' TOC to operate a limited amount[41] of train services on a proportion of the main rail line used by the majority of GNER's train services. Under the 1993 Railway Act, so-called 'open access' train operators could apply to the ORR to operate a limited service (on a previously awarded franchised route) to 'fill-in' spare capacity in the infrastructure by only paying for track infrastructure access on a marginal cost basis. In 2005, Grand Central asked the ORR for permission to operate a limited open access service from Middlesbrough (in the North East of England) to London. Under the financial procedures of revenue allocation, passengers with full price (non-discounted) tickets could use any operator's train services that over-lapped on the same route. GNER objected to Grand Central's proposed services because a proportion of its revenue would be abstracted[42] by Grand Central. This 'open access' was a potential threat (in theory) to all franchised train operators but GNER still proceeded with bidding for its second East Coast Main Line (ECML) franchise. Indeed, the possibility of 'open access' competition was always a threat to GNER since 2002 when GB Railways Ltd first operated Hull Trains[43] on part of the ECML. Additionally, and according to Wolmar (2005), a year before GNER signed their renewed franchise, Grand Central unsuccessfully attempted to operate another limited service in 2004 from Newcastle to Manchester which would have also used part of the same track as GNER. Indeed, a letter[44] from the DfT explicitly warned that potential "…bidders should take into account the rights and aspirations of…open access and other operators regarding the use of available paths in the timetable."

In spite of the 'open access' threat, the government was initially confident that GNER would meet its passenger revenue targets. GNER attempted to justify the high level of its second franchise bid by referring to the government's support for its franchise revenue projections. GNER referred to an earlier statement by Alistair Darling who stressed that[45]:

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[41] Grand Central applied to operate only three return service a day from London to North East England. See letter from DfT dated 17 January 2006. Correspondence relating to the track access applications by Grand Central and GNER published on 6 April 2006.
http://www.dft.gov.uk/stellent/groups/dft_foi/documents/page/dft_foi_611502.pdf

[42] Revenue abstraction could occur under the ORCATS computerised revenue allocation system whereby full priced and season ticket revenue was allocated between competing companies serving the same stations in proportion to the number of seats available.

[43] GB Railways Ltd (trading as Hull Trains) operated a limited open access service between London and Hull and used spare capacity of the ECML infrastructure – which was predominantly used by GNER.

[44] Letter dated 10 May 2006, released under the Freedom of Information Act 2000 from the DfT. [Alistair Darling was Secretary of State for Transport.]

[45] Alistair Darling, Secretary of State for Transport. [Comment from a debate in the House of Commons on 19 December 2006 referring to this earlier quote by Alistair Darling.]

> "…the government has [previously] crawled all over the GNER figures in the last few weeks to make sure they stood up. They do, and we will deliver them by carrying more passengers."

On 15 December 2006, against a background of several weeks of press speculation, the DfT announced[46] that the government would not be renegotiating new terms for GNER's second franchise.

The (new) Secretary of State for Transport, Douglas Alexander said that:

> "the government has made it clear that rail operators that fall into financial difficulty should expect to surrender the franchise and not receive financial support. To do otherwise could set the precedent that we are willing to bail out operators at extra cost to the tax payer."

Until the DfT could re-tender the franchise, the DfT generously agreed that GNER would continue to operate the service for the next 12 to 18 months under a 'management agreement' whereby GNER's revenue and costs passed to the government in return for the payment of a management fee. Rather than Sea Containers forfeiting their performance bond for unilaterally terminating their franchise, the government permitted the bond forfeiture to be waived if Sea Containers assisted the government in the retendering process to find GNER's successor. In effect, notwithstanding the existence of a performance bond, the franchisee has in effect considerable power if it threatens to withdraw unilaterally its committemtent to its franchise. Immediate termination and total withdrawal from its franchisee would have substantial train operating consequences for the government and passenger traffic. As the 'operator of last resort', under these circumstances, delays would be incurred before the government could replace the failed operator.

In particular, in an agreement with the government, GNER would only be required to forfeit its performance bond if it ceased services earlier than the management agreement specifies and, as an incentive for GNER to assist in co-operating in providing services whilst a replacement was found, it would also receive 'an incentive payment' if (unspecified) targets are exceeded.

Moreover, rather than blaming the flawed franchise for the GNER's failure, the government specifically attributed responsibility to GNER's ultimate parent company, Sea Containers Ltd which itself was in financial difficulties. On 16th October 2006, Sea Containers announced[47] that it was applying for Chapter 11 (insolvency) protection in the US.

The rail minister, Mr Harris seemingly believed[48], at least in public, that Sea Containers'

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[46] DfT Press Release 'Competition commences for operator of Intercity East Coast franchise' 15 December 2006. See: http://www.dft.gov.uk/pgr/rail/passenger/franchises/icecf1/competitioncommences]

[47] See Press Release dated 6 October 2006, 'Sea Container LTD files for Chapter 11' at http://www.seacontainers.com/dynamic/body.asp?DocumentID=665

[48] In response to a question in the House of Commons by from Mr Christopher Grayling MP on 19 December 2006. See:

> "… bid was easily achievable …and …[T]he reason why the franchise had to be pulled was entirely due to problems with GNER's parent company, Sea Containers, and not to problems with the franchise."

But this was not even a view shared by GNER's ultimate US parent company, Sea Containers Ltd. The parent company[49] was adamant that since the funding of GNER was 'ring fenced', the financial difficulties faced by itself would have no bearing on GNER's financial position. Sea Containers Ltd had never provided GNER with any significant or meaningful financial support – apart from underwriting a performance bond. Sea Containers was adamant in its press release that the "control and operations of GNER…are not affected by the (US) Chapter 11 filings….GNER's lines of credit and financial activities have been ring fenced from those of Sea Containers…".
Indeed, rather than not providing funding, Sea Containers actually extracted over £155m in total from dividends from both of GNER's franchises.

5. CONCLUSION

The House of Commons Transport Committee Annual Report 2007 (para 30) recognised the costs involved in the failure of the ECML franchise. The Transport Committee indicated, on GNER's demise, that:

> "there is nothing to celebrate. The costs of severing the franchising agreement and re-letting it so soon effectively represents wasted expenditure as there are no tangible benefits to the travelling public. Improvements and upgrades to services on the East Coast Main Line are now suspended…passengers are missing out as a result. This is not good value for money."

In many ways, the demise of GNER's second franchise within the space of only eighteen months into a ten year period typifies many of the structural, organisational and financial failures of the UK's government's attempts to privatise the country's railway industry. The failure of GNER was particularly pointed on two accounts: firstly, the franchise was issued on one of the country's leading 'flagship' railway routes, and secondly, this was the first major franchise to fail in the second cycle of franchise retendering.

The first round of the franchisees granted initially on privatisation was predominantly noted for their emphasis on government subsidy receipts (in varying amounts) throughout nearly all of the TOCs. And even with these relatively high subsidy levels, some TOCs had significant and growing operating problems and increasingly fragile cash flow difficulties. Some TOCs were financially rescued after the Hatfield accident and others were operated on a management (or cost plus) basis. In the second round of franchises (when the original franchises came up for renewal), the whole relationship of TOCs and the government had changed. Some TOCs, such as GNER, appeared so determined to regain and continue with (what they have come to regard) as *'their'* franchises that unreasonably high and untenable bids were made – based on highly optimistic and undeliverable revenue and passenger targets.

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http://www.publications.parliament.uk/pa/cm200607/cmhansrd/cm061219/debtext/61219-0002.htm

[49] Sea Containers News Release, 6 October 2006:'Sea Container LTD files for Chapter 11' at http://www.seacontainers.com/dynamic/body.asp?DocumentID=665

In effect, substantial over-optimism of both revenue and cost assumptions in order to obtain the franchise has led to the (unfeasibly) high level of premium payment that GNER contracted to pay the government - further distorted by the unbalanced risk sharing between GNER and the government. In this case, unforeseen events and asymmetric information has led to ineffective and failed renegotiation and, ultimately, at a high cost to taxpayers.

Most TOCs were virtually ‘shell companies’ – with their only significant asset being their franchise. Apart from the loss of a relatively small performance bond (which, in effect, was even waived in GNER’s case) the financial risk and penalties (from overbidding and subsequently and unilaterally terminating the franchise) are generally extremely low. The TOCs also incurred substantial ‘sunk’ costs in preparing their bids. It is reported[50] that it cost each bidder between £3-£5m to tender for a franchise, and with the SRA incurring total costs of £40.7m on franchise replacements and extensions over 2001-04. In addition, it was estimated, that with the inclusion of the DfT costs, that the total combined cost of awarding a franchise with just three bidders to be between £11.5m and £17.5m.

The contractual requirements concerning the financial arrangements and structure of the TOCs also ranged from weak to non-existence. In GNER’s case, apart from the specification of minimum liquidity levels, the contract was generally silent on financing and funding arrangements. Specifically, there was no requirement for any profits to be retained in the TOC. Virtually all of GNER’s earnings over both its franchises were distributed as dividends, amounting to £155m that was returned to the parent company, Sea Containers. The franchise made no explicit provision for these distributions to be restricted if Sea Containers’ profitability or liquidity levels fell. Indeed, in the final year before GNER’s collapse, virtually all of its revenue reserves were distributed back to the parent company.

GNER’s demise typifies the inherent difficulties involved in the franchising process. GNER predominantly attributed its failure to unforeseen increased costs and an unplanned fall in passenger revenue – but this was not generally evidenced by examples from other train operators. Additionally, the impact of the London bombings in 2005 initially led to a revenue drop in the case of some operators in the immediate aftermath but not on the scale GNER claimed. GNER also referred to the threat of ‘open access’ competitors abstracting revenue – even though Grand Central planned to operate only three return daily services from London to the North of England and, even then, these services were not planned to start until late 2007 - nearly one year after GNER decided it could not continue with its franchise.

The UK government has preferred not to point the finger of blame for GNER’s failure at its rail franchise model. Rather it has inappropriately attempted to deflect responsibility for GNER’s demise to the financial difficulties of its ultimate parent company, the Bermuda based, Sea Containers Ltd.

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[50] House of Commons Transport Committee, Passenger Rail Franchising, 14th report of session 2005-2006, p22.

The demise of GNER's second franchise so early after its commencement illustrates how franchisees have largely fail to deliver on their commitments because they are poorly designed and co-ordinated, have inconsistent objectives and reflect the problems of dealing with a fragmented and dysfunctional privatised rail industry.

The failing of the franchised method for train operations goes beyond the need of designing a coherent long term development plan. By the nature of their very complex and unwoven business, railway networks seem to operate more efficiency and effectively when they are not privately disassembled and do not operate as separate components involving a myriad of contractual relations between many parties to the industry. This paper has shown that franchising of train services which was, a major aspect of the UK government's rail privatisation process, and typified by the fate of GNER, has failed to provide the benefits envisaged in the government's initial intentions. By drawing on the finding of this paper, a sound basis is provided on which further research can be conducted into other (perhaps more effective and efficient) methods of establishing and operating railway systems as well as examining and comparing the experiences of other European countries.

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Table 1: GNER Financial Performance

Financial year ending	Revenue (£m)	Operating Profit (Loss) after subsidy or premium (£m)	Subsidy(Premium)[1] (£m)	Dividends (£m)
FIRST FRANCHISE				
31 March 1995/6	278.768	15.341	84.24	-
1996/7 **8 months to 4th Jan**	230.574	(5.831)	49.82	Nil
1997/8 **3rd Jan**	323.682	13.246	57.77	-
1998/9 **9th January**	356.528	13.116	42.37	10
1999/2000 **8th January**	371.879	7.934	21.76 Subject to dispute	5
2000/01[2] **6th January**	385.539	26.19	8.87	4.2
2001/2 **5th January**	369.392	28.38	3.09 Subject to dispute[3]	35.2
2002/3 **4th January**	410,450	57.88	0.629*	45.5
2003/4 **3rd January**	429.083	45.03	NIL[5]	19.8
2004/5 **8th January**	475.402	19.881	NIL	26.9
SECOND FRANCHISE				
2005/6 **7th Jan**	477.69	7.24	(52.72)	£8.84[4]
2006/2007 **No financial statements:** **Franchise ended Dec 2006**			(35.35)	

Source: Published financial statements of GNER, 1995-2006.

Notes to Table 1:

[1] The SRA reports different figures for subsidies and premiums in some years. (See SRA Annual Report 2005 pp148-9 for subsidy/premium profile.) The reported figures in GNER's accounts differ, in part, because of some legal set-offs and other compensation/penalty receipts and payments. Additionally, some of the figures in the SRA accounts have not been finalised and some were later recalled because of errors. Other reasons for differences include offset provisions for legal claims and counter claims, compensation settlements, payments, and penalties for meeting or failing to meet performance standards.

[2] On 17 October 2000, a GNER train derailed at Hatfield. GNER's Annual Report 2000/1, p2, noted "…following this incident Railtrack plc imposed a number of speed restrictions on the UK rail network resulting in the cancellation of services, extended delays and significant timetable adjustments." An amount of £23.5m has been received from Railtrack's contractual arrangements and, as a result of "business interruption insurance, £17.025m has been credited as insurance receivable."

[3] After the Hatfield accident, GNER was involved in a dispute with Railtrack and the SRA relating to compensation claims. The premium figures given are from the SRA figures. Sea Containers (Press release 7 May 2004) reported that eventually GNER settled for US$20.7m and, in return, paid the SRA in full settlement of the counter claims.

The published financial statements of GNER show some differences from these SRA figures. In their published financial statements of 2003/4, it is reported (p10-11) that the GNER has made 'several substantial claims against Network Rail…various insurers and other parties involved.' GNER also states it has withheld 'payment of certain Network Rail Infrastructure Services Ltd's invoices during 2001 and 2002.' As a result of a complex legal settlement in December 2003 '…GNER and NRIS Ltd reached agreement settling all GNER's claims arising out of Hatfield incident and relieving GNER from any obligation to repay amounts previously withheld…'. However, the SRA counterclaimed by claiming a financial interest in the compensation of £25m. The financial statements do not identify the premium payments in these specific years. The premium payments have been netted off against legal compensation packages.

[4] As a result of FRS21 (and the adoption of IFRs in 2005), UK financial statements do not now show proposed dividends – the adjusted total (paid) dividend is £35.74m. However, the 2005/6 accounts were restated as a result of only showing dividends paid. A dividend of

£26.9m was declared on 29 April 2005 in respect of the 53 weeks ended January 2005 and dividends of £8.84m have been declared and paid in respect of the 52 weeks ending 7 January 2006. The total dividend of £35.74m was included in the 2006 accounts on restatement and then the 2005 dividend was removed. Over the combined two years, in cash flow terms, the total amount of dividends paid was not affected.

[5.] Although no direct subsidy or premiums were received or paid in 2003/4 and 2004/5, as a condition of the terms of its two year franchise extension, GNER agreed to spend £100m 'on rebuild, more reliable and longer trains, modernised stations and new car parks.' [See: Memorandum by the GNER (ref: For115) to Select Committee on Transport, 11th May 2005, para 1.5.]

Table 2.

GNER's Second Franchise Premium Profile.

	(£m)
2005/6	(52.75)
2006/7 Franchise terminated in December 2006	(35.35)
2007/8	(81.39)
2008/9	(114.02)
2009/10	(164.29)
2010/11	(207.86)
2011/12	(250.81)
2012/13	(294.41)
2013/14	(343.52)
2014/15	(396.21)
TOTAL (2005/6 – 2014/15)	(1.940.41)

[Discounted total[1] = £1.277bn.]

Source:

The above premium payments are from the DfT following a request to the DfT under Freedom of Information Act 2000.

[See publicly available letter dated 10 March 2005: www.dft.gov.uk]

Notes to Table 2:

[1] Discounted at 6.1%, (see Sea Containers News Release August 11, 2006, para 3b, p12). The NPV was calculated using the government's discount rate of 6.1%. [Note: On a discounted basis, (from 2005 to 2015) this total premium of £1.94bn, on a net present value basis, amounted to £1.277bn.]