THE RAILWAYS IN A THIRD TERM

"Integrated, accountable and publicly owned"

Pre-election briefing March 2005

In September 2004 Labour Party constituencies and affiliates voted at the annual party conference to adopt a policy of "resolving the fragmented structure of the [rail] industry by introducing an integrated, accountable and publicly owned railway".

It has long been recognised that such a move would be supported by an overwhelming majority of the public and would prove immensely popular at a general election. This pre-election briefing shows how this policy can be put into practice in a third term and beyond. We can afford to bring the railways back into public ownership. Such a move would make sound financial sense as well as reaping significant social, economic and environmental benefits in the longer term.

SUMMARY

- the government's hopes for a "rail renaissance" with its attendant social, economic and environmental benefits have been frustrated by a privatised rail industry that has absorbed extra public investment without delivering real improvement or growth
- ministers have proclaimed their commitment to "the principle of a public private and partnership" for rail. But the private sector is not delivering value for money on the railway – the public sector has proved itself to be more efficient and cost effective
- any private sector investment in the railway must ultimately be paid for by farepayers and taxpayers – with interest. Around **£800m** a year is taken out of the industry as returns to private lenders and investors – a total leakage of more than £6b since 1996
- the majority of passenger services could be taken into the public sector by 2013 at no cost. Reductions in regulatory bureaucracy and in the subsidies paid to private Train Operating Companies could save more than £200m a year
- restoring network infrastructure and rolling stock to public ownership would entail a one-off increase in public debt by, at most, 2.15 per cent of GDP. This would not breach the government's Golden Rule or Sustainable Investment Rule. This capital investment could produce immediate savings of £300m or more a year in current spending
- rolling stock companies should also qualify for a one-off windfall tax on excess profits. If this was calculated and applied in the same way as Labour's 1997 windfall tax on privatised utilities, additional revenue of £100m to £200m could be yielded
- overall, the most conservative estimates indicate that bringing the railway system back into public ownership could produce immediate cash savings of **£500m** a year or more through reduced bureaucracy and leakages to private providers of finance. Over the medium and longer term, reintegration would produce further savings and improvements as the post-privatisation trend to waste and cost-escalation is reversed.
- without direct public control over costs, money spent in support of the rail industry will prove unsustainable, creating pressure to shift the burden to passengers through fare rises and cuts to services.

1. INTRODUCTION

In 1998 the Labour government promised a "rail renaissance" for the twenty-first century as part of a radical shift to a more efficient, equitable and environmentally sustainable transport system. Since then the railways have received substantial and sustained increases in public investment under the Ten Year Plan for transport.

Public funding for the railway industry has now reached a level of around £4.5 billion a year,[1] supplemented by above inflation fare increases. The results of this unprecedented injection of new money, however, have been extremely disappointing, because of poor performance and cost escalation in the privatised railway industry.[2]

In early 2004 the government announced a major review of the structure and organisation of the railway industry, acknowledging that "taxpayers and farepayers alike need to know that their money is being well spent and that increased spending will improve performance".[3] That review concluded that the record levels of investment had failed to produce the desired results because of "problems caused by privatisation", which had bequeathed "an inefficient and dysfunctional organisation coupled with a failure to control costs".[4]

Despite this recognition, however, the government stated that it remained committed to "the principle of a public and private partnership for the railways" and proposed only modest changes to the way in which the industry is regulated – primarily, abolishing the Strategic Rail Authority and dividing its functions between Network Rail and the Department for Transport (and Scottish Executive where appropriate). These measures are contained in the Rail Bill that is currently progressing through parliament.

In September 2004 constituency and union delegates at the Labour Party's annual conference debated policies for inclusion in Labour's manifesto for a third term. An overwhelming majority voted to adopt a policy committing Labour to "resolving the fragmented structure of the industry by introducing an integrated, accountable and publicly owned railway".[5] At the time of writing 97 MPs have signed an Early Day Motion endorsing this policy.[6]

At the time ministers and government spokesmen argued that such a move would be too expensive and would divert much-needed public funds from priority areas such as health and education. It was repeatedly claimed that bringing the railways into public ownership would cost "£20 billion" and deprive the industry of "£70m a week" in private sector investment.

This briefing shows how Labour's policy could be put into practice in a third term. It shows that, far from being a costly diversion, failing to take action now would be financially imprudent as well as socially and environmentally short-sighted.

[1] Alistair Darling, written statement to House of Commons, 10 February 2005.
[2] Catalyst, Renaissance Delayed: New Labour and the railways, July 2004.
[3] Alistair Darling, statement on the railways, House of Commons, 19 January 2004.
[4] Department for Transport, The Future of Rail, July 2004.
[5] Labour Party National Policy Forum, Final Papers 2004.
[6] EDM 382: 'Public Ownership of the Railways'

2. GOVERNMENT POLICY: A PUBLIC PRIVATE PARTNERSHIP FOR RAIL

Current government policy has sought to enshrine "rail's status as a public service, specified by Government and delivered by the private sector".[7] In response to calls for reintegration of the railway industry under public ownership, ministers and government spokesmen have repeatedly stressed their commitment to "the principle of a public and private partnership".

"Public private partnerships" have been a signature policy for the present government, constituting one of its most important, if controversial, devices for reforming public services. Advocates of the policy have made two points very clearly that are highly relevant to debates about the railways:

- **Public private partnerships should not be seen as a device for finding "new money" for investment in public services.** Money that private firms invest in service provision is always paid back by the public through tax-funded contract fees and/or user charges. In fact, this will always prove to be more expensive to the public than direct public investment and provision, because the private sector invests in the expectation of a healthy return, whereas the government is always able to borrow more cheaply through low-interest gilt and bond issues.

- Because they are always a *more expensive* way of financing services than direct public investment, **public private partnerships are only justified if they can be shown to offer "value for money"** – that is, that the private sector is so much more efficient or innovative than the public sector that this advantage more than makes up for the extra costs of finance. "Unless the … project delivers net savings through greater efficiency, the eventual cost to the taxpayer will be at least the same under conventional finance where the Treasury borrows in the capital markets".[8]

Discussion of public private partnerships have laid emphasis on the importance of "what works". In assessing the government's public private partnership for rail, we need to focus clearly on the costs and benefits for passengers and tax-payers.

Does the private sector bring "extra" investment?

The most common response of the government to arguments for extending public ownership of the railways is that the private sector delivers investment in the railways that would be lost if the public sector performed these functions. For example, it has been repeatedly claimed that private companies are bringing "£70 million" or "£73 million" of investment to the industry every week that would be lost if the public sector took over.[9]

But, as the IPPR has said in relation to PFI projects, this is a "bogus" argument. All investment in the railways must ultimately be paid for by taxpayers and farepayers, one way or another. The money that private firms invest is not "free" money that they are donating to the industry. It must all be paid back – with profits and interest – through the fare box or through grants and subsidies paid out of tax revenues. In particular, as things currently stand:

- analysis by industry experts has shown that as much as 60 per cent of this "private sector investment" is investment by Network Rail, whose borrowing is already guaranteed by government and is widely regarded as undeclared public debt[10]

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[7] Department for Transport, The Future of Rail, July 2004.
[8] IPPR, Commission on Public Private Partnerships, June 2001, p79.
[9] Alistair Darling, House of Commons, 20 July 2004; speech to Labour Party Conference, September 2004.
[10] Rail Business Intelligence, 7 October 2004; Modern Railways, November 2004.

- the remaining investment by Train Operating Companies ("TOCs") and Rolling Stock Companies ("ROSCOs") is financed through past or guaranteed future income streams – passenger fares and the annual £1.4 billion in tax-funded subsidies, paid to TOCs and passed on to ROSCOs[11]

There is, then, no pure financial argument for keeping the railway industry in private hands. "Private investment" is always paid for the public – with interest. Research for Catalyst by Professor Jean Shaoul of Manchester University indicates that this constant leakage of cash from the industry in the form of profits and interest payments could be in the region of **£800m** every year, or £15m every week. The total figure could be more than **£6 billion** since the completion of privatisation in 1996.[12]

Does the private sector deliver value for money?

The only good argument for running the industry as a public-private partnership would be a "value-for-money" argument – that is, if the private sector is delivering desired service outcomes more effectively or at a lower total cost than the public sector would be able to. This is the real question to ask about whether any service or industry should be in public or private hands. Thus there have been debates about whether the disciplines of market competition, or private firms' culture of efficiency and innovation, means they can do some things better than the public sector – from installing and maintaining telephone lines to performing elective medical treatments.[13]

But **no one believes that the private sector offers good value for money when it comes to running the railway system**. It is now recognised that the limitations of British Rail were primarily due to low levels of government funding and investment – in fact it delivered the most efficient railway system in Europe in return for the lowest public subsidy.[14] The Conservatives' attempt to introduce competition into the railway industry did not lead to greater efficiency or innovation.

Instead, the substitution of adversarial for cooperative relationships, and loss of industry knowledge, has resulted in a massive escalation of costs, poor or indifferent performance, and, most notoriously, a serious compromising of safety standards.[15] And the government's own review of the structure and organisation of the industry made clear that its problems arose from the fragmentation and lack of strategic direction that were an inevitable consequence of privatisation.[16]

In principle, then, there is no justification for leaving the rail industry in private hands. The private sector does not deliver "extra investment" that would otherwise be lost – the investment is paid for through fares and government financial support, and could be had more cheaply if the government were investing directly in a public sector railway. And there is no evidence that the involvement of the private sector makes for a more efficient or innovative railway – on the contrary, in this case it is clear to all that a publicly owned, publicly accountable railway would be a better railway.

If language used by ministers suggests that they are committed to running the railway as a public private partnership as a matter of "principle", this would be in the face of all evidence and experience shows that reintegration under public ownership would be the better solution.

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[11] C Wolmar, 'Private sector investment proves to be a mirage', Rail magazine, 28 May 2003
[12] See Appendix
[13] For a review of some of these debates see S Sachdev, Paying the Cost?, Catalyst, 2004.
[14] Catalyst, Renaissance Delayed?, Chapter 2.
[15] See, inter alia, R Ford, The Rising Cost of Britain's Railways, Transport 2000, 2003; G Crompton and R Jupe, Delivering Better Transport?, Public Money and Management, 22(3), 2003; B Martin, British Rail Privatisation: What Went Wrong?, Public World, 2002.
[16] Department for Transport, The Future of Rail, July 2004.

2. CAN WE AFFORD IT?

A further argument that has been used to resist calls for a publicly owned railway has been that there is "not the money in the till" for "an expensive renationalisation", implying that it would be irresponsible or indulgent to use government funds when it could be spent on "schools and hospitals".

At present, the government is spending around £4.5 billion a year of public money on the railway. As has been argued, and will be set out in more detail in following sections, if the railway was entirely in public hands the government could save money on this annual bill and get a better railway in return.

But we do have to get from here to there. And some – though not all – of the steps needed for a fully public railway would involve some "one-off" transitional costs:

- returning passenger services to the public sector would cost nothing if franchises were left to expire, or be **cost-neutral** as penalties paid for early termination of contracts would only reflect expected profits that the public will have to cover anyway

- acquisition of trains currently owned by rolling stock companies would constitute a one-off capital investment of around £4.5 billion, increasing total public debt by approximately **0.4 per cent of GDP**

- reconstituting Network Rail as a public corporation would nominally transfer at most £21b of debts to the government's balance sheet, increasing total public debt by approximately **1.75 per cent of GDP**

As is well known, the government has imposed upon itself rules as part of its strategy for economic stability and fiscal credibility: the "Golden Rule", that over an economic cycle the government must borrow only to invest; and the "Sustainable Investment Rule", that total public sector net debt must not exceed 40 per cent of GDP.

The second of these rules, in particular, is arguably too restrictive – most OECD countries carry public debt way above this level, and even the EU's Maastricht Treaty requires only that it should not exceed 60 per cent of GDP. There is in addition a strong argument that it makes no economic sense to impose limits on public debt without regard to the capital *assets* owned by the government and whether any of those assets yield additional revenue for the government (as would be the case with rail infrastructure and rolling stock).[17]

Furthermore, in the case of rail it is increasingly argued that Network Rail's borrowing in particular should be counted as total public sector debt anyway, and is already regarded as such by the financial markets – so its inclusion "on paper" would make no material difference to the government's real financial position.

But for present purposes such arguments need not bear upon the question of what we do with the railways, because **bringing rail back into public ownership in a third term would not require any breach of the government's fiscal rules**. As we have seen it would involve no real increase current spending – indeed would bring immediate and growing savings – so the Golden Rule would not apply. And the capital investment in re-acquiring the rolling stock and network infrastructure would involve a one-off increase in total public debt by 2.15 per cent at most. This poses no problem for the "Sustainable Investment Rule" at a time when public sector net debt stands at around 34.5 per cent

[17] Malcolm Sawyer and Kathy O'Donnell, A Future for Public Ownership, 1999, p51

of GDP and is projected to peak at 37.1 per cent of GDP in 2009-10.[18] Demand for government bonds from insurance and pension funds is currently strong, so any increase is unlikely to involve a significant rise in yields.[19]

Furthermore, these one-off costs need to be assessed against the ongoing benefits that would accrue once these steps had been taken. These include:

- **immediately reduced costs of tendering, contract management and regulation** as all arms of industry work directly to public interest objectives set by government instead of pursuing private returns within a contractual and adversarial framework

- **immediately reduced cash leakages and costs of finance** for all arms of the industry, as investment is financed through interest on government debt instead of the higher returns currently paid to private lenders and shareholders

- **increasing efficiency savings over the medium and longer term** arising from reintegration of the industry, rebuilding of industry knowledge and relationships of trust, reversing the trend to cost-escalation and dysfunction seen since privatisation

Bringing the rail infrastructure and rolling stock back into public ownership would then be a one-off capital investment that would produce immediate and increasing annual savings on the current account. Far from diverting funds from schools and hospitals, it could *release* new money for current spending on priority services. Like any sensible investment, then – such as buying a house or training for a qualification – it is "worth doing" even if some initial costs are involved, because over the longer-run it makes financial sense. In fact it would be imprudent *not* to do it if we can afford it – to put it off unnecessarily, because we are forgoing the savings that would arise from the move.

3. STEPS TOWARDS PUBLIC OWNERSHIP

The following sections of this briefing set out in more detail what would be involved in taking the key arms of the current railway industry back into full public ownership: passenger services, rolling stock and network infrastructure.

a) Passenger services

At privatisation passenger services were split between 25 private train operators franchised by Office of Passenger Rail Franchises, latterly the Strategic Rail Authority (SRA). The government is currently in the process of restructuring passenger franchises to bring the total number down to 19 by 2006.[20] The policy of putting passenger services out to tender was premised upon the idea that competition between private operators and with other modes of transport would bring down costs and increase passenger revenue, ultimately relieving the treasury of the need to subsidise services with public funds.

But as the House of Commons Transport Select Committee found, "the vast majority [of franchises] have not been able to produce the efficiency gains that were confidently anticipated at the time of

[18] HM Treasury, Budget 2005, Economic and Fiscal Strategy Report, March 2005, p30
[19] Institute for Fiscal Studies, The IFS Green Budget, January 2005
[20] Alistair Darling, Statement to House of Commons, 19 October 2004.

privatisation".[21] Analysis of the TOCs performance by Professor Jean Shaoul has demonstrated that "the private train operators are no more efficient either in financial or non-financial terms than their publicly owned counterpart".[22] In fact, it has now become clear that British Rail was already highly efficient and that there was little scope for reducing costs further without jeopardising services – a fact illustrated when train operators had to cancel services after losing too many of their workforce. Today train operators' costs are increasing, necessitating above-inflation fare increases and annual subsidy payments that reached £2b in 2003-4 and are projected to remain around £1.4b a year over the coming period.[23]

The real story behind these figures is a classic example of how "public private partnerships" can fail to effect a real transfer of risk from the public to the private sector. Train operators not delivering on their franchise requirements have received extra subsidies as the SRA felt the need to "step in to protect what is ultimately a public service",[24] meaning that "astonishingly large sums of taxpayers' money have been used to prop up palpably failing businesses".[25] In the year 2003-2004 total subsides to TOCs were £650m higher than had been planned in 2000.[26] It has been reported that more than half of the train operators have been "bailed out" in this way,[27] including Virgin, ScotRail, Central Trains, Anglia and Connex.

At the end of 2003 it was thought that more than a third of all franchises were operated under "management only" contracts, with firms paid a guaranteed margin above the costs of operating the franchise. As Alistair Darling has himself said in relation to "cost-plus" arrangements in maintenance work, such deals "give contractors little incentive to cut costs or respond to problems quickly".[28] As the Select Committee has said, it means that franchises "were no longer expected to function in the entrepreneurial, risk-taking way that was one of the fundamental justifications for private sector involvement in running train services."[29] At the beginning of this year Arriva Trains Northern, First North Western, Great Northern, Virgin Cross Country, Virgin West Coast and Wessex Trains were all being run on a cost-plus basis.[30]

In only one case has the Strategic Rail Authority stepped in to remove a private operator from a franchise. Connex received more than £50m on top of its budgeted subsidy in 2002 and was then stripped of the South Eastern franchise the following year when improvements failed to materialise. Since then South Eastern Trains has continued to outperform private sector comparators on commuter routes in and out of South London, for a reduced public subsidy.[31] Inexplicably the government is now proposing to re-privatise the service as part of the new Integrated Kent Franchise, and is now accepting bids. 58 MPs have signed an Early Day Motion calling for the service to remain in the public sector.[32]

Analysis and practical experience demonstrates that private train operators bring nothing to the provision of passenger services on Britain's railways. And there is a considerable cost – the cost of

[21] House of Commons Transport Select Committee, The Future of the Railway, 2004, p37
[22] Jean Shaoul, 'Railpolitik: The financial realities of operating Britain's national railways', in Turning the Corner?, edited by Francis Terry, Blackwell, 2004
[23] Alistair Darling, written statement to House of Commons, 10 February 2005.
[24] 'Railways agency bails out two more networks', Financial Times, 8 March 2002.
[25] Transport Select Committee, The Future of the Railway, p38
[26] J Shaw and J Farrington, 'A Railway Renaissance', in A New Deal for Transport, edited by I Docherty and J Shaw, Blackwell, 2003
[27] 'Britain's railways are going nowhere', Financial Times, 29 January 2003.
[28] Alistair Darling, Statement to House of Commons, 28 October 2004.
[29] Transport Select Committee, The Future of the Railway, p39
[30] Keeping Track list of passenger franchises, http://www.keepingtrack.co.uk
[31] SRA, National Rail Trends 2004-2005 Quarter Three, 2005
[32] EDM 95: 'South East Trains Franchise'

tendering and managing franchises; the cost of covering train operators' profit margins, much of which is covered by public subsidies; and the cost of operational fragmentation and an adversarial blame culture that hinders the provision of an efficient, effective and integrated service.

Learning from the success of South Eastern Trains and running all passenger services in the public sector would bring considerable savings and benefits:

- there would be no need for tendering processes, currently costing the SRA around **£3m-£4m** a time and averaging out at one a year[33] – nor would the cost of preparing bids need to factored into the cost of running services as TOCs currently do

- less resources and bureaucracy would be needed for administering and monitoring contracts – the SRA does not publish a breakdown but a conservative estimate might be to suppose that "franchise management" accounts for a third of its operating budget, saving **£30m** a year

- subsidies and fare revenues would no longer be drained from the industry as returns to private lenders and investors. Dividends paid annually by TOCs to parent companies averaged **£170m** in the years 2001-2003.[34] Last year total profits soared to **£290m**, a 20 per cent increase on the year before[35]

- not only has South Eastern Trains shown that the public sector can run passenger services more effectively and efficiently than the private sector, but this advantage would be multiplied as more franchises came under direct control thus bringing the benefits of **better coordination and integration** across the network

The simplest way of bringing passenger operations back into the public sector would be to take them over as and when current franchises expire. The current state of the franchise map would suggest the following rough timetable:

- two franchises are currently under renegotiation or being renewed on an annual basis: **Cross Country** and **West Coast**, both with Virgin. These arrangements could be terminated as soon as the government wished. In addition the **Integrated Kent Franchise** is currently being bid for, but contracts have yet to be signed

- the current **Silverlink** franchise expires next October; Great Western, Great Western Link and Wessex Trains are due to be combined into a the new **Greater Western** franchise; and Thameslink and WAGN are to be combined into the new **Greater Northern Franchise**. These could all then be run in the public sector from 2006.

- ten franchises are due to expire between 2007 and 2013: **Island Line**, **South West Trains**, **Midland Main Line**, **South Central**, **c2c**, **Gatwick Express**, **First Scotrail**, **Greater Anglia**, **Trans-Penine**, and **Northern Rail**. The **East London Line** will be completed around 2010 and could be run in the public sector from the beginning

- the recently signed **GNER** franchise is due to expire in 2012 or 2015, dependent upon performance; two recently signed franchises for **Arriva Train Wales** and **Chiltern** are due to expire in 2018 and 2022 respectively. **Merseyrail**, which is operated as a concession not a franchise, expires in 2028.

[33] Tony McNulty, Written Answers, House of Commons, 7 June 2004
[34] Research for Catalyst by Professor Jean Shaoul
[35] 'Train firms' 20 per cent profits rise sparks fury', Evening Standard, 28 January 2005

This would mean that under a policy of letting franchises run their course the last franchise would come back under public ownership in 2022, with the vast majority returned by 2013. This picture would change, however, if new long-term franchises were signed for the eight franchises currently under negotiation or planned for tender over the next two years.

Passenger operations could of course be brought back into the public sector more rapidly at any time by terminating contracts that have already been signed. This would entail the payment of compensation, which would normally be expected to reflect the profits forgone by the rail operators. These are profits that the government was going to have to pay anyway, on top of the actual costs of operating the service, so the effect of compensation payments is to render the early termination of contracts cost-neutral from a public finance point of view.

However other savings would begin to accrue as a result of running trains in the public sector, as the need for regulatory monitoring decreased and as train operations became progressively better integrated with each other and with the overall system. There would, then, remain a strong financial case for bringing train operations rapidly into public ownership even if this did mean compensation payments due to early termination of contracts.

It needs also to be remembered that, if past experience is anything to go by, many if not most new franchises could prove unable to deliver the services originally specified in their contract and will be seeking additional subsidy. If the Department for Transport refused to offer "bail-outs" in such instances and instead relieved failing operators of their franchises without payment of compensation, then the majority of train services could be back in the public sector very quickly indeed. If such a policy had been operated over the past few years, less than half of train franchises would still be in the private sector today.

b) Rolling stock

Although public attention and debate has largely focused on the performance of train operating companies and the subsidies paid to them, it is arguable that the biggest beneficiaries of privatisation have been the three Rolling Stock Companies (ROCSOs) who own the trains and lease them to the TOCs.

Unlike the TOCs and infrastructure operator, ROSCOs were not subjected to any regulatory framework at the time of privatisation, despite the concentration of ownership and calls to rectify the anomaly at the time and since. The IPPR paper widely seen as the blueprint for the government's current rail policy concludes that "the danger of cartel suggests either strong oversight by the competition authorities or some form of public ownership. If the rolling stock companies were to abuse their market power, this question would need to be faced."[36]

Since their original management buy-outs all three ROSCOs have ended up in the possession of high street banks, making their finances particularly hard to follow.[37] What is known is that of the £1.4b in public subsidy paid annually to train operators, around £1b a year is now passed on to ROSCOs in the form of train leasing costs. ROSCOs have in turn been able to achieve operating profits of around 45 per cent, and have paid out £1.3 billion in dividends to their parent companies since privatisation.[38]

[36] Tony Grayling, Getting back on track, IPPR, 2001. See also SRA, Rolling Stock Strategy: Responses to the Consultation, January 2004.
[37] The three companies are Angel, Forward Leasing, and Porterbook, currently owned by three high street banks – Royal Bank of Scotland, HSBC and Abbey National respectively.
[38] Research for Catalyst by Professor Jean Shaoul.

A key reason for these extraordinary figures seems to arise from the fact that franchises run for periods far shorter than the useful life of trains, which can be up to 40 years. In order to cover the "residual risk" of new franchisees not taking forward existing leases ROSCOs have been allowed to set leasing charges at a level that would recoup most of their costs within the first few years of their trains' life. In fact, as it is highly unlikely that changing franchises will substantially affect the overall requirement for trains on the network, this risk is largely theoretical, but it means that over a train's lifetime ROSCOs may receive leasing charges two or three times its cost.[39]

Meanwhile questions have been raised about the quality of the new trains that the ROSCOs are delivering – the latest NAO report found that "most have been late entering service and are not as reliable as they should be; often, they are less reliable than the old trains they have replaced". A key factor is the fragmentation and conflict of private interests consequent upon privatisation: "there is a lack of organisational coherence within the railway industry; not all of the key public and private sector parties involved have common interests in, or have been sufficiently incentivised for, the smooth introduction of new trains".[40]

But last year's rail review again ducked the issue, implicitly admitting that there is no "competitive market" and that ROSCOs are receiving premiums way out of proportion to any real risk carried, but promising only a "longer-term strategy" for rolling stock about which we have yet to hear more.[41]

Given this enormous outflow of public money and questionable performance, the case for returning rolling stock to public ownership is overwhelming:

- bringing rolling stock back under public ownership would entail a public investment of around £4.5b – the current value of ROSCOs assets. This would entail a one-off increase in total public debt by around **0.4 per cent of GDP**

- ROSCOs' average dividend payments of **£163m** a year certainly represents an underestimation of the value that is taken out of the industry by their parent companies, who as finance providers will also receive substantial interest payments. Evidence that trains are paid for in the first few years of service suggests that as much as **£600m** of current annual leasing charges could be saved[42]

- in addition to these immediate financial benefits we could expect **ongoing improvements in quality and cost control** as train manufacture and delivery is better integrated and planned to meet the needs of the railway system

In addition, there is a particularly strong case for imposing a one-off **windfall tax** on the ROSCOs' excess profits. In 1997 the new Labour government imposed a windfall tax on privatised utility and transport companies based, in the words of the Chancellor, upon their "under-valuation and under-regulation at the time of privatisation".[43] Perversely, the only reason that the rolling stock companies were excluded from this measure seems to have been that they were not regulated at all,[44] despite the widespread view that this was an oversight. The dramatic upward correction in the value of the companies following privatisation and their substantial profits ever since confirms suspicions that this was "the one that got away".

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[39] Research for Catalyst by Professor Jean Shaoul.
[40] NAO, Strategic Rail Authority: Improving Passenger Services through New Trains, 2004.
[41] DfT, The Future of Rail, 2004, p70
[42] Research for Catalyst by Professor Jean Shaoul.
[43] http://archive.treasury.gov.uk/pub/html/budget97/speech.html
[44] The tax was applied to "companies privatised by flotation and regulated (or with a subsidiary regulated) by relevant privatising statutes". Inland Revenue, Press Release, 2 July 1997.

In 1997 the windfall tax was levied at 23 per cent of the difference between the real company value and its price at the time of floatation – a deliberately light rate intended to take account of the financial position of the companies then subjected to it. Using exactly the same method for calculating "real" company value with reference to average annual profits, applying the same rule to the ROSCOs would yield a windfall revenue of around **£100m**. Alternatively, we could just look at the prices for which the three companies were sold on in the years immediately after privatisation – at around £900m above their initial floatation value – which would suggest a windfall tax of around **£200m**.

c) Network infrastructure

Network Rail was established by the government following the final debacle of Railtrack as a "public interest company" that would be better geared to social objectives and relieved of the need to pay dividends to private shareholders. Following the government's 2004 rail review and the impending abolition of the Strategic Rail Authority, Network Rail is to take a stronger role in leading the industry, assuming responsibility for overall performance from April 2005.

There is no doubt that Network Rail is a major improvement on its predecessor. Investment has increased, performance is improving, and important steps such as bringing network maintenance back "in house" have brought us closer towards the integrated, strategically coordinated, and cost-effective railway that we need.

But this remains unfinished business. In legal and financial terms Network Rail remains a private monopoly, autonomous from government and dependent upon private finance for its investment. Whatever the merits of "public interest companies" and "mutual enterprises" in other areas of social provision, even their enthusiasts have questioned the applicability of such models to the maintenance, operation and development of the railway network.[45] Because of the level of investment needed and the risks associated with it, the government has had to back the company with £21b in contingent loans, provoking controversy as to its "private sector" status for the purposes of national accounts.

And their remains confusion over Network Rail's accountability and the extent to which it can be relied upon to act in the "public interest". This has been dramatised by arguments over the role of the Rail Regulator – some have argued that there is no longer any need for independent economic regulation "to protect taxpayers from shareholders",[46] while the outgoing Regulator viewed Network Rail as a "monopoly provider" with its own corporate interests. What is clear is that, as the Transport Select Committee noted, the attempt to arbitrate this potential conflict is "inefficient and highly expensive", with the regulator "duplicating the work of the company's management" by undertaking "parallel exercises assessing renewals' requirements of the rail infrastructure".[47]

For these reasons "it is being increasingly recognised that the whole pretence of NR being in the private sector is costing a lot of money and has led to a situation where it cannot be adequately policed".[48] The Transport Select Committee concluded that "it is time for the Government to cut through this tangle of responsibilities and take direct ownership of Network Rail on the grounds that a

45 P Maltby, In the Public Interest?, IPPR 2003; see also 'Thinktank lays into Network Rail structure', The Guardian, 16 September 2002.
46 P Maltby, In the Public Interest?, p77
47 Transport Select Committee, The Future of the Railway, p34
48 C Wolmar, 'Pretence of a "private" NR costs rail industry dear', Rail, 2 February 2005

Railways Agency, incorporating the rail infrastructure, will ensure both the lowest borrowing costs to meet the necessary funding requirements and direct, democratic accountability".[49]

What would be involved in such a move?

- Network Rail's current debts of £21b would be added to the government balance sheet, marking a one-off nominal increase in total public sector debt equivalent to **1.75 per cent of GDP** – nominal because this is already widely regarded and treated as debt for which the government has already taken responsibility

- in 2003 it was calculated that bringing the rail infrastructure into the public sector and financing its investment by issuing gilts could have saved **£80m** in annual interest charges[50] – a figure that was likely to increase as its debt increased.[51] The latest figures show Network Rail's annual interest payments running at around three times the level for 2002-3,[52] suggesting that the saving could be as much as **£250m** a year

- reconstituting Network Rail as a public corporation would also have the effect of obviating the need for independent economic regulation. Abolition of the Office of Rail Regulation would save around **£14m** a year – running costs currently covered by a "license fee" paid by Network Rail

- a public corporation, owned by government and accountable to parliament, would be the best vehicle for achieving the **overall focus and coordination** of the industry envisaged for Network Rail under the government's rail review

A first task for a publicly owned infrastructure company would be to address the fragmentation and cost-escalation set in train by privatisation by bringing **track renewals** back in-house. Already Network Rail has stopped contracting out maintenance work, calculating that £300m a year could be saved through improved coordination and no longer needing to meet contractors and subcontractors margins.[53] The results have been impressive.[54] The obvious next step is to reintegrate track renewals and enhancement, whose separation from "maintenance" is another artificial legacy of privatisation[55] and makes up the majority of Network Rail's annual expenditure.[56] Even if costs were reduced by only half the proportion estimated for maintenance work, we could expect savings in the region of **£400m** a year or more.

Abolition of the Office of Rail Regulation would necessitate the return of **safety regulation** to the Health and Safety Executive. The transfer of safety responsibilities to the Office of Rail Regulation that is currently planned invites the subordination of safety to economic imperatives – if safety standards are currently expensive to meet that is a result of industry fragmentation, not standards that are too high.[57]

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49 House of Commons Transport Committee, The Future of the Railway, 2004, p29
50 'Ministers "wasted £80m on Network Rail"', The Times, 29 May 2003.
51 C Wolmar, 'Figures expose fragility of Network Rail experiment', Rail, 11 June 2003.
52 Alistair Darling, written statement to House of Commons, 10 February 2005.
53 Alistair Darling, statement on rail maintenance, 28 October 2003.
54 'In house repair has "cut delays"', The Guardian, 3 February 2004; Network Rail, 'Network Rail sees record performance', press release, 31 May 2004.
55 C Wolmar, Broken Rails, Second Edition, 2001, p217-8
56 Network Rail, Annual Report and Accounts 2004
57 TUC, Why we need an independent rail regulator, 2004

6. CONCLUSION: A PUBLIC RAILWAY FOR THE 21ST CENTURY

The steps outlined above could be taken separately, or all together, and as we have seen there are different options that could be considered in some areas, such as the treatment of passenger franchises with some years to run, or the imposition of a windfall tax on ROSCOs. All of these steps would, however, be achievable, each would bring benefits to the public of immediate current savings year on year and a profound improvement in the efficiency and cost-effectiveness of the rail industry over the medium and longer term.

The table below summarises these gains. Obviously figures cannot always be precisely calculated, and these estimates based upon plausible assumptions should be taken as indications of the kind of sums that would be involved. Even the most conservative estimates suggest that bringing the railways into full public ownership could produce immediate cash savings in the region of **£500m** a year. But even this could only be the beginning.

Costs and benefits of a publicly owned railway

	PASSENGER SERVICES	ROLLING STOCK	NETWORK
One-off costs	**None**	**0.4 per cent on public debt**	**1.75 per cent on public debt**
Reduced regulation	Franchise management - £30m pa	None	Abolition of ORR - £14m a year
Reduced leakage to private investors	£170m - £200m pa	£200m - £600m pa	£80m - £250m pa
Other potential benefits	No more tendering – average £3m pa	Windfall tax (one-off) £100m- £200m	Renewals integration £400m-£800m pa
Immediate savings (total)	**£203m – £233m pa**	**£200m - £600m pa** (+ windfall)	**£94m - £264m** (+ renewal savings)
Practical timescale	1-17 years*	1-2 years	1-2 years
Long-term benefits	**More efficient, reliable and better integrated services**	**Better trains delivered to meet service needs**	**Clear leadership of industry in the public interest**

** Assumes that current TOC franchises are allowed to expire – or termination penalties paid, which would cancel reduced leakage saving for remainder of period.*

In focusing on the economic and fiscal arguments, this briefing has not examined the important question of how a publicly owned railway should be structured and organised. But it is important to recognise that a return to public ownership should not mean a return to the centralised and hierarchical structures of British Rail.

We need the railway to be responsive and accountable, with decentralised decision-making processes allowing full involvement for regional bodies, Passenger Transport Executives and local authorities. We also need to ensure adequate representation at all levels for those who use the railways, and those who work on them – a board split equally between government, passengers and workforce might be a good starting point for discussion. Developing plans for a public railway that is genuinely accountable and democratic could be an exciting challenge for a third term Labour government.

The costs of inaction

Ministers have suggested that we cannot afford to take the railways back into public ownership. The reality is that we cannot afford not to. Continuing with the status quo means continuing with low growth, poor performance, compromised safety – and spiralling cost escalation.

Since the 10-year-plan for transport was launched we have seen public money committed to the railways go up from £3b a year, to £3.5b a year, to £4.5b a year – at the same time as targets are abandoned and ambitions scaled back. The Exchequer will not bear this increasing burden indefinitely – sooner or later there will be pressure to shift the costs of privatisation to passengers, through fare rises and cuts in services. Either way, the public loses.

Britain's railway has a vital role to play as part of a rejuvenated transport strategy for the twenty-first century. As the problems of car congestion intensify, rail can offer the fairest and most effective means of relieving pressure on the roads.[58] The poor state of our transport infrastructure has been recognised as one of the major barriers to our economic progress and prosperity in the years ahead.[59] Achieving a "modal shift" of freight traffic from road to rail will be a crucial step to achieving our environmental objectives under the Kyoto treaty.[60]

To meet these public interest objectives, we need a railway that is public owned and publicly accountable, and which delivers a real return on the public money invested in it.

58 P Goodwin, What Future for Rail, All Party Parliamentary Rail Group, November 2003
59 CBI, Transport policy and the needs of the UK economy, March 2005
60 Freight on rail: on track for sustainability, http://www.freightonrail.org.uk

APPENDIX – LEAKAGES OF PUBLIC MONEY UNDER PRIVATISATION

(£000s)	1996	1997	1998	1999	2000	2001	2002	2003
TOCs' subcontractors' operating margins (1)	32,500	44,880	35,932	45,819	34,165	50,637	61,852	65,953
TOCs' cost of capital (2)	78,194	22,386	179,803	111,484	149,996	5,428	158,026	141,245
TOCs' leakages (3)	110,696	67,266	215,735	157,303	184,161	56,065	219,878	207,198
ROSCOs' subcontractors' margins (4)	13,833	15,874	17,450	11,800	12,602	12,059	12,157	12,500
ROSCOs' cost of capital (5)	394,400	365,900	398,500	295,500	368,222	314,064	290,472	293,563
ROSCOs' leakages (6)	408,233	381,774	415,950	307,300	380,824	326,123	302,629	306,063
Railtrack/Network Rail's maintenance subcontractors' margins (7)	67,000	69,000	68,000	66,000	69,000	47,000	NA	30,000
Railtrack/Natwork Rail's renewal contractors' margins (8)	21,000	24,000	30,000	83,000	92,000	136,000	NA	83,000
Railtrack/Network Rail's cost of finance (9)	181,000	145,000	120,000	123,000	246,000	274,000	NA	165,000
Railtrack/Network Rail's leakages (10)	269,000	238,000	218,000	272,000	307,000	457,000	NA	278,000

Source: research for Catalyst by Professor Jean Shaoul

Notes

(1) Have assumed that subcontractors margins are 5% of their receipts from TOCs, using TOCs' other costs in Table 10 as cost of subcontractors
(2) Total cost of finance is operating profit before interest and tax, less tax.
(3) Sum of 1 and 2 above
(4) Have assumed that subcontractors margins are 5% of their receipts from ROSCOs, using ROSCOs' operating expenditure less labour costs and depreciation as cost of subcontractors
(5) Total cost of finance is operating profit before interest and tax, less tax.
(6) Sum of 4 and 5 above
(7) Have assumed that maintenance subcontractors margins are 5% of their receipts from Railtrack/Network Rail, using Railtrack's operating expenditure less labour costs and depreciation and Network Rail's 'maintenance charges' as cost of maintenance subcontractors
(8) Calculated as 5% of additional fixed assets (renewal costs)
(9) Calculated as interest paid and dividends for Railtrack and interest payable for Network Rail
(10) Sum of 7+8+9