FINANCIAL ANALYSIS OF PUBLIC POLICY

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Financial Analysis of Public Policy

Introduction

It is believed that privatisation would result in greater efficiency, healthier competition and would be more beneficial to the consumer. In the case of British railway service, privatisation was adopted to reduce the burden of the government and to generate more income to the government. This move helped in reducing public sector borrowing, as there were lesser subsidies to be provided to the railways due to privatisation. After the passing of the 1993 Railways Act, British Railways was privatised. The privatisation led to the separation of ownership and control of the railway infrastructure including tracks, signals, and stations. The passenger train operations were separated from the other activities. Despite the benefits the privatisation was expected to bring, it also carried a number of disadvantages. The problems faced pre and post privatization of railway service and franchising rail operations are not peculiar to the United Kingdom alone. Many developing countries faced similar problems, and privatisation has not appeared to be an effective solution due to the increase of costs and the disregard of public interest among several other reasons. This paper analyses the public policy of privatising the British Railways from a financial perspective and relates the issues of rail franchising to the conditions prevailing in developing countries.

Problems in Running British Rail Prior to Privatisation

Private companies ran railways in the UK until the year 1948. The post war labour government recognised the need for improving the conditions and functioning of the railways in the country and decided to nationalise railways. In 1948, the state owned the railways in Britain, and promises were made that there would be all round improvements in railways including renovation of stations and improvements to rolling stock with the ultimate aim of enhancing the conditions of services to the commuters.

Year 1962 witnessed the handing over of the responsibility of the railways to British Rail for operating the service, maintaining the tracks, and managing the rolling stock. By the 1980s and 1990s, there were efforts taken by British Rail to improve the profitability and reduce the level of government subsidies to railways. However, the governmental restrictions on British Rail to increase the passenger fares and freight charges made it impossible for British Rail to achieve its objectives.

The governmental restrictions coupled with the deep recession led to severe financial struggle, and British Rail had to rely more on public funding for running the railway service. With the increased financial difficulties, British Rail could not maintain the quality of rail service. Passengers faced the problem of travelling in old, dirty and overcrowded trains. Trains were running late frequently, and many train services faced cancellations. Many of the commuters lost their faith in rail service and chose to travel by alternative means of transport, namely, by bus or by car. The trains were badly in need of maintenance, and there were no spares available for carrying out effective repair works.

Considering the problems faced by the British Rail, an investment programme with an outlay of £ 1 billion was prepared with an expectation that the organisation would get government funding. However, due to recessionary conditions, British Rail had to arrange the funds from its own sources as the government did not have means to contribute to the refurbishment programme (Veljanovshi, 1991). This left British Rail with no other options except selling off the lands owned by it. With the announcement of the Treasury that it would not provide any additional funding to British Rail, the problems were accentuated.

It was concluded that like any other state owned undertakings, railways have to be privatised to overcome the financial issues. However, Veljanovshi (1991) argues that the Conservative Government did not have any precise planning done with respect to privatisation of the railways. In many developing countries including China and India, though a remarkable progress is being made in the railways, there are still disparities in the growth of railways as compared to the economic growth in general (Lin and Jianhua, 2004). The railways are still unable to meet the demand of people of the respective countries. Since railways in the developing countries form a part of the national infrastructure, they require huge investments as happened in the case of British Rail. Increasing railway construction has always been a priority of the national governments. However, the developmental plans are often facing shortage of allocations from national budgets due to huge budget deficits, thus, slowing down the progress of railways growth. Generally, this has been the experience in many of the developing nations.

Collapse of the Second GNER Rail Franchise

As a result of the 1993 Railways Act, the structure of railways in Britain underwent radical changes. There were a number of private companies established to take care of the different functional area of railways. ‘Railtrack’ was established as the privatised infrastructure manager. This company was separated from 25 other private Train Operating Companies (TOCs), and three freight operating companies were established in April 1994. The rest of the organisation of British Rail was split into three rolling stock leasing companies (Roscos) and 13 infrastructure service companies (Iscos). These and several other support organisations formed the extensive supply chain backup for the Roscos (Tyrrall, 2003). In addition to these establishments, 19 maintenance supply companies were also formed. Thus, the rail industry in the UK was subdivided into two major segments. The first one consisted of train, signalling, and station infrastructure, and the second one included the train operating companies.

Great North Eastern Railways Ltd (GNER) was one of the major train operating companies. This company undertook the operation of a prime arterial route with trains running from London to Scotland. With its first franchise obtained in the year 1996, the company renewed its franchise for train operating services in 2005. During the period of first franchise, GNER was able to manage its finances successfully because of the substantial subsidies received by it from the government. GNER originally agreed to pay considerable premium to the government from the revenues to be earned in the second franchise. However, during the second year of operation of the second franchise, GNER suffered major financial setbacks, and this led to the termination of the franchise to the company. The reasons for the abysmal performance of GNER will be analysed in the following sections.

GNER was one of the larger TOCs to win a franchise for the major arterial route that ran along the east coast of England. State owned British Railways Board (BRB) established the Inter City East Coast Ltd (ICEC) in June 1994 in anticipation of privatisation later on (Li and Stittle, 2014). After the passing of Railways Act in 1993, the assets and liabilities of BRB were vested with ICEC Ltd. Great Northern Railways Limited, a subsidiary of Sea Containers UK Limited, took over the assets and liabilities of ICEC Ltd in April 1996, and the company was renamed as Great North Eastern Railways Limited in October 1996 (Li and Stittle, 2014).

GNER operated train services in most important routes, such as London – Edinburgh, Leeds, and Newcastle. The company was expected to run the initial franchise successfully based on a subsidy profile. However, a major derailment occurring in October 2000 in the outskirts of London largely vitiated the results of the first franchise. Since the cause of accident was found to be negligence to maintain the tracks by the infrastructure owner Railtrack, it led to several financial, operating, and political implications for the companies operating within the railway system. Operating restrictions placed on TOCs created a major distortion in the funding and revenue stream of GNER and other operators. The accident also resulted in substantial legal and financial claims and compensation involving Railtrack and the Strategic Rail Authority (SRA). These compensation and claim payments were outside the purview of franchising arrangements and led to the revision in the profiles of subsidy receipts and premium payments by the TOCs.

One of the relevant issues in this connection was the extent to which GNER could influence Network Rail (formerly Railtrack) to enhance the investments in the maintenance and keep the tracks in a fit condition. Network Rail lacked initiatives to invest since the track charges are to be based on the increased costs, and any revision in the track charges is to be met by GNER from the taxpayers' money in the form of subsidies. Another reason is that Network Rail was keen on cutting costs with adverse consequences on the track quality. Wolmer (2005) argues that the only objective of Railtrack was to maximise profits and sharing dividends at the cost of new investments in tracks and safety of operations. This left Railtrack without any initiatives to keep the tracks cope with the additional traffic.

An analysis of the financial performance of GNER during the first franchise operations (1996-97 to 2004-05) shows a declining annual subsidy from £49.82 m in 1996-97 to £3.09 m in 2001-01 (see Table 1 below). Although the franchise was renewed for three more years until 2004-05, little or no subsidy was paid to or premium received by GNER. The annual revenue of GNER stood at £323.68 m resulting in a profit of £13.25 m (together with a subsidy of £57.77 m) for the year 1997-98, which was a full accounting period. The revenue for the year 2002-03 was at £410.45 m recording a growth of 32.6% and the operating profit of £57.88 m (Li and Stittle, 2014). The subsidy during this period was negligible. GNER could increase its profits due to the raise in the national passenger traffic. Shaoul (2005) has identified the revenue protections to the TOCs in the form of payment of full tickets by passengers. The increase in some unregulated fares like super savers and unrestricted train tickets were some of the other reasons that accelerated the profits. Revenues increased by 4.5% for 2003-04 and by 10.8% for 2004-05. Despite the increase in revenues, the operating profits showed a decline with £19.88 m for 2004-05. This amounts to a decline of 67% for 2004-05 over 2002-03 (Li and Stittle, 2014).

Table 1: GNER Financial Performance (Public Financial Statements of GNER, 1995 - 2005 cited in

Li and Stittle, 2014)

Financial Year Ending	Revenue (£ m)	Operating Profit (Loss) after Subsidy or Premium (£m)	Subsidy (Premium) (£m)	Dividends (£m)
First Franchise				
31st March 1996	278.68	15.341	84.24	-
1996-97 (8 months)	230.574	(5.831)	49.82	NIL
1997-98	323.682	13.246	57.77	-
1998-99	356.528	13.116	42.37	10
1999-2000	371.879	7.934	21.76	5
2000-01	385.539	26.19	8.87	4.2
2001-02	369.392	28.38	3.09	35.2
2002-03	410.450	57.88	0.629	45.5
2003-04	429.083	45.03	NIL	19.8
2004-05	475.402	19.881	NIL	26.9
Second Franchise				
2005-06	477.69	7.24	(52.72)	8.84
2006-07	(no financial statements)		(35.35)	

During the period of the first franchise, GNER paid a total dividend of £146.6 m to its parent company Sea Containers UK Limited, and this amount was almost equal to the total of the net earnings of the company during the first franchise.

The second franchise awarded to GNER was signed for a period of 7 years in March 2005 with an automatic renewal for a further period of three years in case of meeting specified performance standards. Although no information was released on the actual contract figures, reports stated that GNER paid £300 m more than the nearest rivals to get the contract awarded (Li and Stittle, 2014). While the first franchise was characterised by the subsidies, the second franchise was worked out according to premium-based franchises. However, there were ‘cap and collar’ contractual arrangements by which the government would share the losses if the financial results of a TOC did not meet certain levels. Taking into consideration this new arrangement, the premium payments expected from GNER have been calculated and are shown in the following table.

Table 2: Estimated Premium Payments of GNER (Li and Stittle, 2014)

Financial Year	**£ m**
2005-06	(52.75)
2006-07 (Franchise Terminated in Dec. 2006	(35.35)
2007-08	(81.39)
2008-09	(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 2005-06 to 2014-15	(1940.41)

The increased premium payments were achievable based on a substantial and sustained growth in passenger traffic flows. GNER was expected to meet the obligations for the additional payment of premiums to the government from the increased revenues resulting from increased passenger traffic.

The comparison of the revenues for the last year of the first franchise and the first year of the second franchise reveals that the revenue during the first year of second franchise increased from £475.4 m to £477.7 m accounting for a growth of only 0.5%. GNER had to meet the obligation of paying £52.7 m to the government by way of premium, which left the company with a fall in the operating from £19.88 in the previous year to £7.24 m in the first year of the second franchise.

The financial position of GNER showed a poor growth in the passenger revenue. In addition, the obligation to pay substantial premiums to the government and the setting aside of considerable reserves for dividend payments to the parent company also contributed to the reduced operating profit of £7.2 m out of the total passenger revenue of 427 m. In the previous year, GNER earned passenger revenue of £423.5 m that resulted in an operating profit of £19.9 m. The company predicted a 10% growth in the passenger revenue while submitting the tender for the franchise. Contrary to this expectation, the passenger revenue increased only by 0.5%, which was negligible. For the financial year 2006-07, GNER had the obligation to make a premium payment of £33.35 m to the government. The continued deteriorating financial liquidity and the balance sheet for the year 2006 showed the increase in the net current liabilities. The balance sheet produced by GNER shortly before its collapse exhibited that the company had only few assets in its possession. There was a reduction in the net assets of the company from £27.4 m in 2005 to £5.45 in 2006 Li and Stittle, 2014). This was due to extinguishing company's previously accumulated reserves by distributing substantial dividends of £35.74 m to the parent company.

Even though no financial statements were prepared by GNER for the year 2006- 07, the year of its collapse, the parent company Sea Containers Ltd admitted that GNER underperformed the financial projections in its franchise bid due to the dwindling passenger traffic. Sea Containers Ltd admitted that against the forecasted growth in the passenger revenue, the actual growth was only about one third. In the franchise bid, GNER assumed an increase in the passenger revenue up to £510 m for the fourteen-month period from May 1 2005 to June 30, 2006, which is 9.9% revenue growth as compared to the growth in the same period in 2004-05. However, the actual passenger revenue grew only by 3.3% (Li and Stittle, 2014).

One of the main contentions of Sea Containers Ltd is that the loss of more than fifty percent of the passenger revenue resulted from the reduction in the number of passengers travelling to London because of terrorist activity around King Cross station and London terrorist bombings. However, this claim is not supported by passenger traffic flow figures available to the public. Jupe

(2007) cites the reduction in passenger miles over the two franchise periods as the reason for decline in revenue. Despite the increase in passenger numbers by 70% over the period between 1993-94 and 2005-06, the passenger miles increased only by 33%.

Extent of Achievement of Rail Franchising

The stated objectives concerning privatisation included the achievement of greater efficiency, increased shareholding leading to stiffer competition which, in its turn, should enhance the benefits and quality of services provided to the consumer. In order to achieve these objectives, there was the need to adopt certain regulations on the part of the government. The regulations need to be incentive; besides, they need to allow investments to be adequately rewarded from unsubsidised revenues to let utility network privatisations remain successful. It is also intended to maintain the quality level of services and restructuring of the networks to ensure effective competition for the network service (Newbery, 2004). Conventionally, franchising has been used as a form of business organisation based on licensing and other forms of agency arrangements which was thought to work well with utility network privatisation efforts.

Franchises for train operating companies were awarded by competing tendering. The successful bidder is allowed to use the rail infrastructure in exchange for the obligation of providing a minimum required service to the passengers with the payment of lowest subsidy by the states or the highest premiums by the operators. By franchising, the government acting as the franchisor has passed on its responsibility to enforce the quality of services to the statutorily established independent regulators appointed as franchisees. Franchising can be regarded as an effort of sharing risks and lifting the resource constraints of the franchisee (Carney and Gedajlovic, 1991; Lafontaine, 1992). However, in a context where there are no means to verify the efforts of agents, there is the likelihood of potential agency problems, such as ‘moral hazard’, ‘free riding’, ‘inefficient investment’ and the like (Grossman and Hart, 1983).

The train operator franchising scheme adopted by the government was based on franchising proposals advocated by Irvine (1987). Irvine believed franchising would enhance competition among the train operators by the creation of competitive tensions that would be evolved from the contractual relationships among the operators. He also anticipated that the efficiency and market responsiveness of the operators would also go up. Murray (2005) also substantiated the view that competitive tensions would be a superior method to privatise utilities as compared to earlier methods. With franchising the government expected that the subsidies could be eliminated in the long run (Jupe, 2007). On the contrary, Wolmer (2005) and Terry (2001) argued about the poor organization of UK rail privatisation, and they considered the privatisation to be a financially wasteful exercise that would fail in the periods to come.

On similar grounds, Crompton and Jupe (2003) found that privatisation wants to possess fundamental flaws resulting in excessive costs, poor quality of service ultimately leading to increased public subsidy to support the system. On an overall assessment, Jupe (2005) stated that the franchising in the railways has not been able to transfer substantial risks to the private operators. The system also could not gain a tighter control over the costs of operating as even the British rail had. Based on the interviews with the potential bidders of train service franchises, Preston *et al.* (2000) observed that the majority of the prospective bidders had problems in gaining an in-depth understanding of the franchise. The authors state that the franchisees could not gain an understanding of the structural and regulatory provisions surrounding franchising.

Strategic Rail Authority (SRA), a state regulating authority created to supervise the train services, had also criticised the incomplete nature of the franchising models and commented that TOC model became increasingly unfeasible. There is a viewpoint that the terms of franchising agreements do not indicate the precise expectations from TOCs, and the franchises were unable to withstand the exogenous shocks of the previous years. Apart from SRA, the government had also turned critical about the operations of TOCs. The Transport Plan for the country had criticised the limited benefits resulting from the franchised TOC model. One of the major flaws of the franchising model identified by the Transport Plan is that the seven-year contract period is too short to encourage long-term planning and investment by the franchisees for ensuring higher level of quality in service delivery. President of Sea Containers Ltd, the parent company of GNER, criticised the fragmented franchising model because operating separate infrastructure and train services is much higher than that of integrated railways.

Another problem related to franchising is that fragmentation in franchising resulted in reduced competition. With one company owning the rail infrastructure and three companies owning rolling stocks, three large companies owned more than 48% of share in the operators of the rail franchises in the UK. This has restricted new entrantsto the franchising market hindering healthy competition in the train service. The Transport Committee together with the member of the House of Commons organised the barriers to the new entrants. Those barriers were mainly related to: (1) the cost and complexity involved in bidding for the franchise, and (2) the emphasis on the past performance of the prospective bidders. The emphasis on the previous performance has become a serious barrier for the companies who have not managed rail franchises earlier. There were serious weaknesses in contractual inter-face relationship between TOCs and Network Rail which added to the failure of the franchising model in railways. Shaoul (2006) reports that the government's attitude to sharing the losses of TOCs as the 'operator of the last resort' has impeded the initiatives of the TOCs to make any substantial investments to improve the service quality. Overall, the franchising system and the fragmentation of ownership created little competition, introduced moral hazard and failed to provide the investment incentives to the detriment of passenger quality service and to the government exchequer funds.

Other Train Operating Companies ceased to exist because of a number of reasons including the expiry of franchise term, bankruptcy, and merger with other companies or premature withdrawal of the franchise. This supports the point that the failure and the financial struggle were not the unique features of GNER, and the disintegrated franchising model without a long-term planning has to be blamed for the failure of the TOCs.

Additional Problems in Applying Franchise Model

In case there are no contingency plans developed for meeting the exigencies happening when one or more franchisees fails to meet its commitments, the state and the public would be left completely unprepared. Additionally, a state of a ‘near panic’ may develop putting the day-to-day life and activities of the public out of gear. Under normal circumstances, increase in the rail services patronage to the franchisees would result in increased passenger service and reduction in government subsidies. However, the franchisees demanding higher subsidies at times when the patronage is low may also try to persuade the government to increase the subsidy with the increase in the use of utility services on the plea that they lack capacity to handle additional demand.

The increased patronage and resultant capacity crisis may also lead to significant deterioration in the quality of service offered by the franchisees especially in the rail system. Franchisees may try to find excuses for late running and cancellations due to any other reasons from the capacity crisis issue. Another problem is that where the franchising is treated as an ideology and a means of promoting competition by the government, it is easier for an experienced operator to ‘capture the regulator’. This presupposes that when the franchise is in a troubled state, the government may decide to end up with increasing the payments to that operator and continue serving the customers instead of facing the criticisms for the interruption of major services.

The other problem related to the above issue is the notion of institutional lock- in. This refers to a situation where a political community representing a group of public officials make themselves identified with a particular policy and the related worldview. The identity of the policy community and more specifically the job security of its leaders become more intricate with defending the policy irrespective of the success or failure of the franchisees in providing efficient service to the public. The political community would like to ensure that the policy (franchising) does not fail. This may have adverse effects on the provision of quality service to the public.

Conclusion

The early demise of the second franchise of GNER soon after its commencement is a typical illustration of how franchisees have failed to deliver quality service. The failure is largely attributable to the poor design and coordination of the franchising model. Apart from this, the inconsistent objectives and the problems of dealing with a fragmented and dysfunctional rail industry have also been identified as the reasons for the failure. The failure of the franchised model for operating rail services underlines the need for designing long-term plans for the development of infrastructural facilities.

The complex nature of railway networks exhibits chances of functioning more efficiently when different components of functionality are not privately disassembled and are made to operate as separate components involving varied contractual relations among different parties operating in the industry. This paper supports the view of Shaoul (2006) that the government’s attitude in sharing the losses of TOCs as the ‘operator of the last resort’ has been the main reason for the failure on the part of the TOCs to venture in making any substantial investments to improve the service quality of the railways.

This has led to other problems for both the organizations and commuters as every other problem stemmed from this initial problem. This paper has shown that franchising of UK train services has failed to provide the benefits anticipated by the government with its initial intentions of privatising. Basing on the findings of this paper, a further research on the operation of railway systems in other European and developing nations can be conducted from the perspective of comparing the effectiveness and efficiency of operations.

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