FINANCIAL TIMES

April 1, 2013 5:09 pm

UK rail franchising overhaul underwhelms

By Mark Odell and David Oakley


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The overhaul of rail franchising last week following the West Coast fiasco has done little to appease investors, who have labelled the government's management of the process "amateurish" and a "shambles".

Patrick McLoughlin, transport secretary, had hoped the move would draw a line under the debacle, which left the rail franchising programme in disarray. He was forced to cancel the award of a contract to run the West Coast mainline to FirstGroup last October, after failings at every level of the Department for Transport.

The crisis came as officials faced the busiest period of retendering of passenger franchises since privatisation in the mid-1990s and as austerity measures were forcing deep cuts on all government departments.

When Mr McLoughlin announced a radical overhaul of the timetable for letting rail franchises last week, he said it "would provide long-term certainty to the market".

However, investors remain far from convinced, highlighting just how badly the West Coast fiasco has damaged confidence in the sector.

One investor, who holds shares in National Express, FirstGroup and Stagecoach, says: "I still think there is a lot of uncertainty over rail franchising. There needs to be more clarity from the government on this. We like these companies. They have competent management teams and are good investments, but the government is in a shambles on franchising."

A top 30 investor in FirstGroup, Go-Ahead and Stagecoach, adds: "The jury is out on this. There has been so much confusion and bad publicity that it makes you very cynical. We like the companies, but the government has been less convincing over franchising. The West Coast debacle highlighted what is for us a very amateurish approach from government officials. They need to raise their game on this."

Rail margins

Another top 20 investor in both National Express and FirstGroup says: "This is a positive sign [overhaul of the franchising

Franchise	Revenue (£bn)	Ebit (%)
First Great Western	1.02	-1
Virgin West Coast	0.98	4
South West Trains	0.81	6
Southeastern	0.72	3
East Coast	0.67	1
Southern	0.61	3
First Capital Connect	0.50	1
London Midland	0.33	-1

timetable]. But there are still question marks over the process. We have faith in the companies but not so much in the government."

The antipathy of shareholders contrasts with the more optimistic welcome to the timetable by trains operators, who believe the move will allow them to boost the profitability of their rail operations.

As part of the overhaul, the government will have to renegotiate the terms of almost all the contracts before retendering them. The revised schedule will see extensions granted to 12 of the existing 15 privately operated franchises as the government tries to smooth out the retendering schedule to avoid overstretching resources by having to relet more than three or four contracts a year.

Profit margins in rail are traditionally low – averaging about 3 per cent – with investors attracted to the industry because of the strong cash generation of most of the franchises. Train operators would welcome the chance to improve the terms on any extension as most of the existing franchises are falling short of forecasts because of the recession.

"We will be seeking to get the best deal we can," a senior manager at one of the UK transport groups told the FT last week. "If we don't like the terms then we won't sign and we'll walk away." The government has put its management team, which runs the state-controlled East Coast main line, on standby in the event of a failure to reach agreement.

As part of the shake-up, the East Coast operation will become the first big franchise let as it is returned to the private sector. This is one of only three contracts to be retendered before the next general election in 2015, compared with the 12 out of 16 planned for in the same before West Coast blew up.

Of the other two contracts, Essex Thameside, which covers services between London and Southend, will also be let as franchise. Thameslink, in contrast, will be tendered as a lower-margin management contract in a change to the way Department for Transport has run the railways in recent years, reflecting the risk of disruption to services from extensive engineering work.

It is too early for analysts to assess the full impact on rail profitability of the changes as negotiations have barely started. But Mark Manduca, analyst at Bank of America Merrill Lynch, says the consensus is that trains operators will achieve a 2 to 4 per cent margin on all contract extensions.

George Muir, a former banker and retired railway executive, believes operators will find it difficult to extract better terms. “It’s certainly not a gold mine and won’t be easy” as the Department for Transport has a good grip on the cost of running the railways, he says.

But Mr Manduca says investors should yet take some solace from the contract extensions, even if the margins remain relatively thin, with investors still more focused on dividend payments.

“Investors in rail have moved from caring about earnings to watching cash flow. They want money back, and the extensions mean you can elongate out the working capital payments.”

Additional reporting by Rose Jacobs

Brussels offers glowing view of state of UK railways

The City may have delivered a fairly damning verdict on the state of passenger franchising, but ministers can take some solace from a more glowing assessment of the state of the UK railways by Brussels, writes **Mark Odell** .

In a comprehensive survey measuring improvements in performance of all 25 rail networks across the 27-member European Union since the 1990s, Britain comes out on top.

The survey – which looked at 14 measures, ranging from the change in satisfaction, punctuality, productivity, reliance on state subsidy and safety – covers the views of 26,000 passengers across Europe.

The UK topped the chart in terms of improvement in passenger satisfaction ratings, modal shift and safety.

The findings should be put into context, however. The survey found that just 55 per cent of passengers were satisfied with railways in the UK, placing the country 11th overall, just behind Belgium on 57 per cent but above the EU average of 46 per cent. Back in 1997, that figure was as low as 32 per cent in the UK.

Rail executives say comparisons only really work against the other large railways in Europe. Germany, France and Italy have a bigger network, but the British system is the most intensively used out of the four.

The improvements in the UK have also come against a backdrop of a large jump in passenger journeys, up 70 per cent since the mid-1990s, compared with 20 per cent in Germany, 10 per cent in Italy and 8 per cent in France

The performance has certainly registered with Siim Kallas, the European transport commissioner, who is trying hard to convince other member states to follow the UK’s lead and liberalise their markets. Mr Kallas said the report would allow people to “identify best practice”, adding: “It shows there are many lessons to be learnt from the UK experience.”