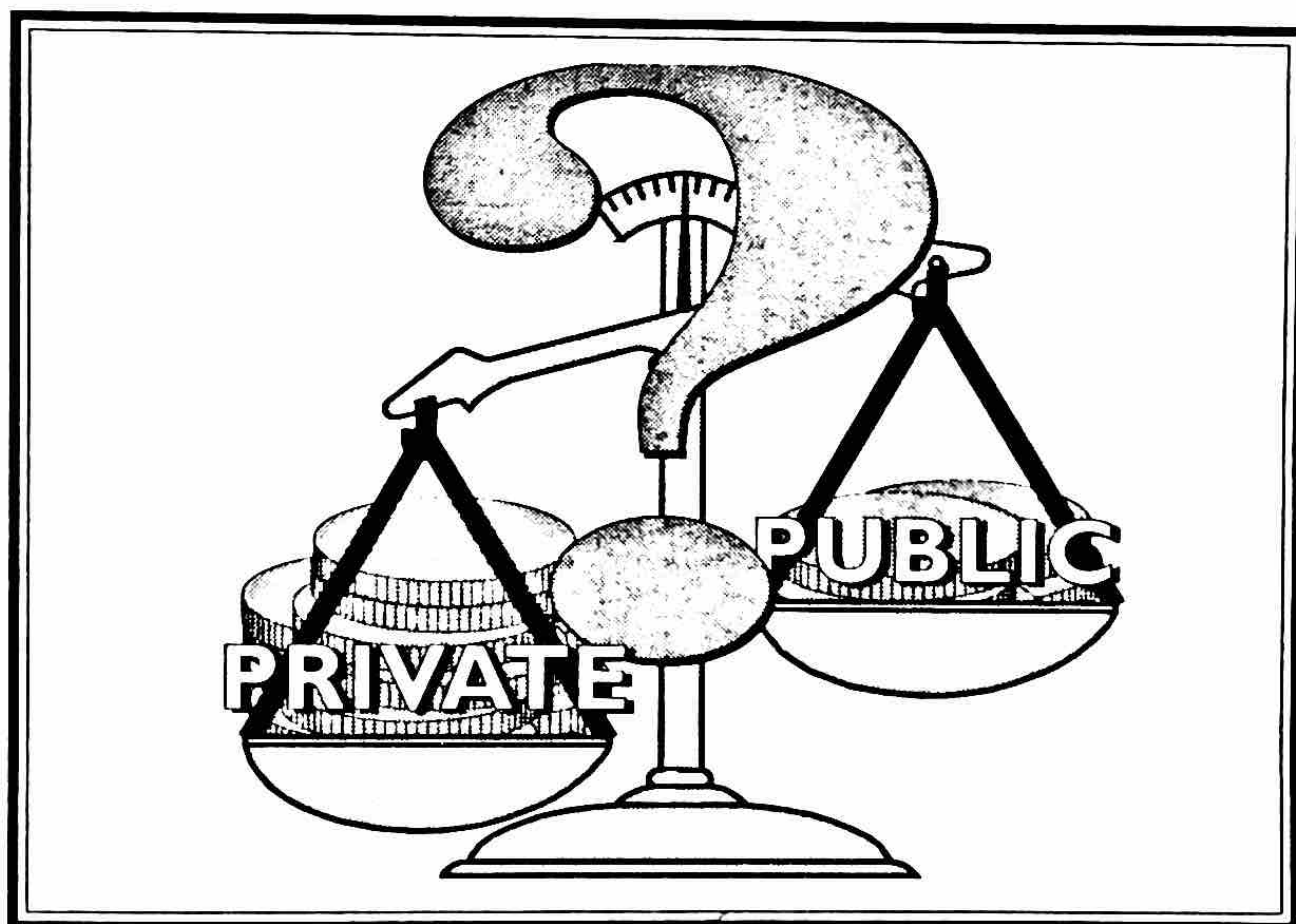
PRIVATE FINANCE IN SCOTTISH TRANSPORT: SEEKING OPPORTUNITIES AND OVERCOMING PROBLEMS

CONFERENCE PROCEEDINGS

Edited by Tom Hart



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FOREWORD

This paper is being published now because of the intensification of the debate on the nature and extent of private finance in Scottish transport. As anticipated at the late 1993 Conference which forms the basis of this Paper, rail privatisation is proving to be extremely complex and controversial. This has not eased conditions for the planned sale of Railtrack in 1996 while there continue to be major problems in assembling private finance for rail passenger franchises involving operations with minimal assets. In the case of both Railtrack and passenger franchises, there is also the common situation of commercial assessments being very dependent on government indications of the scale of public support likely to continue to be available following privatisation.

Regarding ferries, the Scottish Office has now decided not to privatise Caledonian Macbrayne. On the other hand, several schemes for involving private finance in roads remain. The private Skye Bridge is on schedule for completion later in 1995 but extensive studies of the implications of private finance for a second Forth Road Bridge at Queensferry (including tne need for substantial increases in toll) has led to the delay of this project until after a full Public Inquiry. Shadow tolls are now being considered to attract private capital to other road projects such as completion of the M74 yet these have revenue implications for the Treasury and could conflict with the October, 1994, recommendations of the Royal Commission on Transport and the Environment. While public capital spending on roads in Scotland will fall significantly over the next three years, there are no firm indications that private finance could, or should, fill this gap. Issues of the scale and merits of private finance in Scotland remain unresolved.

Tom Hart , 15 March, 1995

Summary of Conference Proceedings
Forte Crest Hotel, Glasgow
10 November, 1993

CONFERENCE INTRODUCTION

Tom Hart, Chairman, Scottish Transport Studies Group

I am pleased to welcome you to this conference which follows on from our preliminary conference on this theme in February, 1990. It comes at a time when issues affecting private finance in transport have become, not only more prominent nationally and internationally, but also of direct importance for Scotland. Could I remind you, by way of introduction, of some of the topics now heading the transport agenda.

The Railways Bill has finally become an Act with Scotland selected as a pilot area for passenger franchises. Since 1990, private finance has also been introduced more widely in the bus, port and airport sectors with studies now proceeding of the possible privatisation of Caledonian MacBrayne ferry services.

Greater efforts are being made to secure developer contributions to transport projects while the Skye Bridge and the proposed additional Forth crossing at Queensferry have attracted considerable attention as innovative schemes using private finance. The deadline for comments to the Treasury on means of encouraging innovation and competition in private financing has just passed with further government decisions expected soon. The November Budget will raise the profile of opportunities for private financing in transport. This review of fiscal and spending policies is taking place within important and under-discussed options for moving the UK economy towards sustainable growth. This topic will attract greater attention after publication in December of the UK government's strategy for sustainable development and environmental improvement.

Today's conference is a unique occasion which brings these issues together. Though rail finance and organisation is one of the most eyecatching and controversial current issues, it is part of a wider framework for change in transport goals, organisation and pricing. The conference will examine these 'framework' issues.

Turning to our first speaker, I am glad that Mr Freeman has found it possible to be in Scotland so soon after the passing of the Railways Bill - but it is by no means his first visit. He has shown a keen interest in overcoming the doubts which the Railways Bill has created in many sections of Scottish opinion and has emphasised that a new era of rail opportunity is dawning - an era in which Scotland can be in the lead. I

was impressed by the evidence which he gave recently to the Scottish Affairs Committee. He spoke then of a strategy for rail growth within UK and EC policies for transport with particular reference to freight potential on the West Coast main line. We look forward to his latest views on the prospects facing Scottish railways and on opportunities for private financing.

PRIVATE FINANCE IN SCOTTISH TRANSPORT : RAIL OPPORTUNITIES

Roger Freeman, Minister for Railways

Sustained economic growth requires investment in both roads and railways, but within a tight rein on public spending and public sector borrowing. Government believes strongly that private finance and private sector management skills have a key role to play in transport projects, whether through outright privatisation or joint ventures. Steps have already been taken to expand the private sector role in airports and ports. The privatised BAA is investing £60 million at Glasgow and port trusts, like Clydeport, are now gaining from the shift to private sector status and abolition of the Dock Labour Scheme in 1989. This change allows access to private capital not possible under previous arrangements.

This approach is now being extended to the rail sector in an ambitious and challenging programme. More generally, I would stress that involvement of the private sector will be deal-driven i.e. there must be benefit to both sides. The private sector will want a fair return and government will want to maximise the transfer of risk to the private sector.

Rail Privatisation

Rail privatisation offers a rich, some would say bewildering, variety of opportunities to the private sector. The key change has been to separate infrastructure from services but it is the intention that both should move to the private sector. Railtrack will be a 'lean' organisation, discharging its functions largely by contracting out and buying-in. Separate Infrastructure Service Companies within BR will contract for various services, particularly track maintenance, and will be sold in due course. Business units for freight and parcels services will also be sold while the passenger network will be restructured into 25 Train Operating Companies which will be transferred progressively to the private sector under franchise agreements. This system allows continuing subsidy to be available for socially necessary services while using franchising to provide competition for the market.

Franchised train operations will not be capital intensive. Working capital requirements - eg payroll and leasing charges, track access charges - are likely to be

offset by subsidy payments(where appropriate) by the Franchising Director and by fares revenue (with a pre-paid season ticket element). Some risk capital will be needed to guarantee performance but amounts would not be substantial. In the first generation of franchises, franchisees may be offered a degree of exclusive use of lines but greater competition in the market is expected in the longer run. This system will give better customer value and better value for money. There will be new incentives towards efficiency, cost reduction and better marketing. The railway user and the taxpayer should both benefit.

Scotland is on course to take the lead in shadow franchises with the financial results and track-record of shadow franchises such as ScotRail providing a basis for bids from the private sector. After these preliminaries, formal invitations to tender will be sent to selected bidders.

ScotRail and the East Coast Main Line are among the first six franchises to be offered. Tender invitations should go out in October, 1994, with private operation beginnning around Spring 1995. We expect that Management/Employee Buy-out Bids will be made for most franchises. Chris Green, who becomes Managing Director of ScotRail in April, 1994, has been quite public in declaring his interest. We very much welcome and encourage MEBO bids. If there is an interest in MEBO, the Franchise Director will be required to exclude BR from any bidding. Our aim here is to transfer risk to the private sector (including a MEBO) rather than to let the risk remain within a public sector BR.

Investment Opportunities from Rail Privatisation

Rolling Stock

There is potential for a massive new leasing market. Clearly, a new market cannot be created overnight. Initially, BR rolling stock will be transferred to three public sector leasing companies. each with a mix of stock to provide alternative sources of supply within each market segment. These companies will be structured to assist the entry of private capital and management skills with a view to the earliest possible complete transfer to the private sector. These companies will not have in-house maintenance; they will be responsible for specifying infrequent, heavy maintenance and will contract for this. Train Operating Companies will be responsible for light maintenance.

Operating leases, rather than finance leases, will be on offer from rolling stock companies. These wil transfer most risk to the Train Operating Companies but the precise transfer of risk will be a matter for negotiation. The majority of train leases will be for a period consistent with the length of operating franchises - but some may be on shorter, or more flexible, terms.

The Franchising Director will be able to specify the use of particular rolling stock by successive franchisees, thereby helping to bridge the gap for lessors between the length of franchises (7-15 years) and the economic life of rolling stock (25-40 years) and so facilitating investment in additional stock and fleet renewals. Many of you will be disappointed that BR chose to use its recent £150 million leasing concession to acquire Network Southeast trains rather than new stcok for the West Coast Main Line but I have no doubt in my mind that the West Coast Route has an assured future. There is still considerable life in existing West Coast rolling stock. Some is only ten years old and it will be replaced as necessary within Treasury criteria for good value.

Infrastructure

Organising infrastructure investment will be the responsibility of Railtrack though this will include joint public/private funding arrangements as for the West Coast Main Line. While Railtrack remains in the public sector, it will be subject to similar financial controls to BR. However, Railtrack will produce strategic business plans with a 10 year horizon. These may include joint ventures with the private sector.

The new system will provide other incentives to efficiency and better services. Track will have to be maintained to the level required in contractual agreements with train operators. Operators may also seek track improvement (such as electrification) to enhance the speed and reliability of services. In some cases, Railtrack and an operator may reach bilateral agreements on proposed investments and extra access charges financed from greater revenue. In other cases, the Franchise Director will have a pivotal role, taking a strategic view and deciding whether he could support investment schemes not giving a payback during the lifetime of a single franchise.

Railtrack will be required to make a return on capital but government is prepared to make capital grants available for infrastructure projects not earning an adequate financial return but offering wider benefits. It will also remain open to PTAs and other local authorities to support investment in schemes with particular local benefits.

Stations

Railtrack will own stations as well as track and signalling. However, the majority of stations will be leased to train operators for the periods of their franchise. Railtrack will remain responsible for structural costs, recovering these through track access charges. Franchisees will have an incentive to maximise commercial activity at stations and one by-product, even on a modest scale, will be stations more amenable to passengers.

At larger stations such as Glasgow Central and Edinburgh Waverley, Railtrack is being asked to explore the possibilities for maximising commercial development through very long leases attracting investment in major refurbishment and development of concourses. BAA provides an example of what could happen, with significant improvements in airport standards and commercial performance since privatisation.

None of this will be at the expense of the primary function of stations to provide for passengers. The Rail Regulator will oversee the position and ensure that all rail operators have a statutory right of access to stations. Access agreements, subject to approval by the Regulator, may entitle train operators to have their own ticket office or to have tickets sold by the station operator at a commission approved by the Regulator.

I hope that I have made the shape of BR privatisation clearer than many have been led to believe in certain recent reports. I am sure that you will agree that the new framework offers the opportunity for extensive private financing and management. The main motive is to encourage increased track and station utilisation, bringing with it lower charges but also higher total income for Railtrack. I look forward to a spiral of rail traffic growth in Scotland, as in other parts of Britain.

DISCUSSION

Clarification was sought on the regime for rail track charging. Mr Freeman explained that, initially, franchise operators would make no direct payments to Railtrack. Payments would be made to the Franchise Director who would then make arrangements for payments to Railtrack. Mr. Freeman suspected that, in the first instance, all 25 passenger franchises would require payments from the Franchise Director which would then be partially recycled through the Director as track charges payable to Railtrack. Another issue which had to be faced was that of open access contracts and charges. Marginal cost pricing had attractions yet, if applied to an outside operator, this would be unfair competition for a franchise holder paying 'full cost' rates. Lastly, the possibility of motorway charging within the time period of franchises had to be taken into account.

Professor Thomson expressed serious reservations about the fragmentation and uncertainty arising from the proposed system in Scotland. He could not see how private capital would be attracted to a ScotRail franchise with no direct control over track. Mr. Freeman insisted that the system was not as complex as many made it out

to be; it created conditions normal in private business. Using the market could itself create good co-ordination while other gains would come from private management skills. But the government would itself have an important role in creating a good, integrated framework in Scotland in 1994 - including determining the level of capital grants likely to be available from central government for Railtrack and encouraging similar grants from local authorities. This could ensure better use of existing levels of funding. Restraint in total public funding was the crucial consideration; there was no shortage of ideas on how to make better use of existing resources and funding. Mr Freeman was convinced that one result of this process would be increased rail investment in Scotland.

Alf Baird queried whether existing port privatisation had been beneficial. Sale prices had been too low, as shown in the recent example of the resale of Medway Ports, while private monopolies had gained control over estuary navigation restraining competition. Mr. Freeman explained that shipping was not his area of responsibility but asked Mr. Baird to raise these points with the relevant Minister, the Earl of Caithness. He pointed out that the Medway sale had come at a different stage in the economic cycle and this had a bearing on prices.

Questions were then asked about how transport plans in Britain and Ireland could link in with EC funding. Mr. Freeman restated his belief in long-term planning for transport infrastructure and commended the example of France, especially the planning programmes of French Railways, SNCF. Government was committed to helping local authorities with integrated applications for EC funding though there was a problem in providing matching funding from UK public sources. Putting too much public money in this direction could cut into other important priorities for the use of public funds.

Malcolm Waugh said that optimism about rail rolling stock leasing and investment was misplaced when, in reality, Strathclyde Regional Council had run into huge problems in financing its proposed lease of new rolling stock. The banks were using the uncertainty of local government reorganisation as a reason for not proceeding without a Treasury guarantee while the Treasury was insisting that leasing must be free of Treasury guarantees. Mr. Freeman sympathised with this problem and promised an immediate meeting between Mr. Waugh, the Dept. of Transport and the Scottish Office in order to resolve an issue which had dragged on too long.

At this point, Mr. Freeman left the Conference for another engagement. The Chairman thanked him for his attendance and answers to the important questions which had been raised.

PRIVATE FINANCE IN SCOTTISH TRANSPORT : OPERATIONS

James Watson, Price Waterhouse

Mr Watson said he would first deal briefly with the history of private financing and then move on to the current situation. He would ask whether policy changes would lead to substantial real change.

Scotland already contained many examples of private operation. It was the norm for road freight and had recently been extended to the leading ports, to all bus services (except Lothian Regional Transport) and to air services. The main recent debate had been on whether private finance could be extended into the infrastructure sector. The Ryrie rules had made this extremely difficult, creating a Catch 22 situation where the Treasury favoured public finance (with lower borrowing costs) for high return projects leaving a residue of lower return projects not likely to attract risk-bearing private finance. But these rules had now been relaxed - firstly with the use of private finance for the second Thames crossing at Dartford and then in the reliance on private finance for the Skye Bridge and second Severn Bridge. Other projects were being pursued following initiatives since the 1992 Autumn Statement.

New Initiatives

These included abolition of the theoretical comparisons with public sector alternatives and the creation of genuine public/private joint ventures sharing risks. Emphasis had also been placed on the extension of leasing in place of direct public financing of capital. The latter reduced public spending since only capital spending by public authorities counted as part of the Public Sector Borrowing Requirement (PSBR).

The motivations behind these changes were three-fold:-

1) to meet government targets for reductions in public borrowing
2) to increase the use of private sector flair in financing and in the management of transport operations
3) to secure better combined results from capital and revenue spending by integrating design, construct and maintenance responsibilities.

Greater competition and risk transference was seen by government and business as a means of increasing overall efficiency and the quality of management.

Problems and Structures within Current Initiatives

Creating effective competition remained a significant difficulty in the case of large infrastructure projects. This issue was receiving attention in Treasury Consultative

Papers. Consortia were required for big projects yet could be deterred from bidding because of the high cost and high risk of putting in an unsuccessful bid. Could ways be found of segmenting contracts to encourage smaller firms to bid? - could provision be made for compensating unsuccessful bidders? What further work was needed in assessing capital costs in relation to subsequent maintenance costs in design, build and maintenance contracts? What conditions should relate to eventual transfers of infrastructure back to the public sector? These issues would arise when infrastructure was considered more fully by Dougald Middleton. For the present, the focus was on operational issues - notably those relating to rail franchises and their relationship with arrangements for rail infrastructure maintenance and improvement.

His general view was that attracting private finance into Scottish railways would be even more difficult than was is the case with roads. The West Coast Main Line already demonstrated the difficulty of assembling consortia for major rail projects. Most were still contractor led, preferring a straight contract to build to one involving a maintenance requirement and the risk of annual payments varying with traffic volumes. High track charges on improved routes could lead to traffic diversion to other rail routes with lower charges or to the road network. Future road charges also remained uncertain with no guarantee of political support for motorway tolls. Firm government responses to the proposals in 'Paying for Better Motorways' were essential to build confidence by private investors. Similarly, clarification was needed of the extent to which government would make capital grants available in recognition of the economic and social benefits of rail use not reflected in direct income. With reference to various hints about road privatisation, it would be preferable to have a structure avoiding a monopoly company and giving multiple companies the opportunity to bid to improve sections of the road network. A final road issue was whether government would move to 'shadow tolls', giving consortia a right to traffic-related streams of income instead of all road taxation being treated as Exchequer income. This would require a major shift in Treasury policy.

Reverting to the issue of private finance for passenger franchise rail companies, this was rendered very problematic by the uncertainty over track charges, uncertainty about future income streams from passengers and from the Franchise Director, the lack of direct control over track and the need to assemble realistic levels of working capital. Much work remained to be done in this area.

Conclusions

Despite these cautious and partly negative views, Mr. Watson concluded by stessing the longer-term advantages of greater use of private finance. Greater use of private finance was vital if the entire economy was to avoid the dangers of continued increases in public spending. Increased reliance on private decision-taking in selecting

transport infrastructure investments and in managing both infrastructure maintenance and transport operations offered the most promising way of increasing the efficiency of the transport sector and of the economy as a whole. This had to be linked with the creation of similar regimes for road and rail track charging; provided this was done, a substantial expansion of the use of private finance in Scottish transport could be anticipated and welcomed.

PRIVATE FINANCE IN SCOTTISH INFRASTRUCTURE PROJECTS

Dougald Middleton, Royal Bank of Scotland

Mr Middleton's first point was that private finance for Scottish infrastructure would be limited unless there was a clear, and confidence-creating, statement of the government's own role in creating conditions encouraging the greater use of private finance. The Royal Bank of Scotland was committed to finding ways of promoting private finance but the government's role remained crucial.

As the economic rationale for private finance had already been covered by James Watson, Mr Middleton concentrated on some of the practical issues to be overcome. Politically, it was worth noting that all the main parties now agreed with the case for increasing the role of private finance though views differed on means and scale.

The biggest problems with major infrastructure projects were those of cash flow. Capital costs were up front whereas income flows took longer to develop - inevitably raising questions over rates of return relative to other uses for private finance. Potentially, banks could make capital available more readily than the raising of equity finance but this was still a high risk area for banks when the only security was future income streams. Anything involving repayments over more than 25 years created huge problems for bank financing yet short franchises were equally unacceptable to banks as a means of approaching major projects.
Diverging into the area which James Watson discussed, bank finance for a ScotRail management buy-out was by no means assured. Cash flow was a crucial issue and there was bound to be uncertainty over future payments from the Franchise Director and from a continuing Strathclyde PTE to a ScotRail franchisee. Such income would be the major part of ScotRail income, being substantially greater than fares income. Bank finance for a ScotRail management buy-out was still conceivable but it would be preferable to be dealing with a 15 year period rather than with the 5 years which had been mentioned for a possible initial franchise. The view taken by banks on the scope for efficiency gains would also be important as would be any steps by government to ensure a high, base level of support for Scottish routes over a 10-15 year period.

Reverting to the infrastructure theme, the need was to minimise areas of risk. Government, for example, should be responsible for acquiring any necessary legal powers for land acquisition, construction and the application of tolls. Design and build or design, build and maintain contracts had also to be framed with clear specifications and a greater willingness by government to bear ground condition risks. The private sector had to be in a position to control operating costs (this was a particular concern in the rail sector because a ScotRail franchisee would not have direct control over track and signalling). At the tendering stage, it was encouraging that the government was now proposing - in the case of a second Forth Road Bridge - payments of around £500,000 to unsuccessful tenderers.

The major problem, however, was that of the level and flow of income. Recession could produce downward movements in road traffic while longer-term rates of growth were uncertain. Where projects were not a natural monopoly, there was also a high risk of traffic diversion to alternative routes. The Forth Road Bridge was commonly seem as a monopoly yet this was not the case. In contrast to the Dartford crossing on the Thames, there was a greater risk that higher tolls at Queensferry would divert traffic to alternative routes (or prevent diversion to the Forth crossing of traffic from Scotland north of the Forth presently proceeding to England and the west of Scotland via the Perth and Stirling bypasses, Kincardine Bridge and A80/M73/M6). National policy could also affect future income flows e.g. levels of transport fuel duty, structure of transport taxation, road pricing, other regulations affecting transport costs and flows.

French Toll Road Companies retained the benefit of government guarantees while, at the other extreme, Mexican road tolls were so high that much traffic continued to use pre-existing, toll-free roads. In the Scottish case, extended use of private finance would depend on greater clarity from government and a willingess by government to spread the incidence of risk rather than load it all on the private sector. Once the market was accustomed to a new but stable framework, it would become easier to assemble funds and enlarge the private role. Mr. Middleton's last points related to the types of immediate acton which could be taken to facilitate private involvement.

Assembling Funds for Private Finance

On the rail front, assembly of funds would be influenced by whether an MBO was successful or whether reliance was placed on a franchise granted to outsiders such as a bus company (or even a US rail company). In the latter case, existing companies would have an established base on which to build further funding. In the former case, funding presented greater problems but would be helped by longer franchises linked with assured minimum levels of payment to the franchisee.

Dealing with roads and bridges, these projects involved heavy borrowing and very little equity. The cost of this borrowing varied with the risk level. Several sources of debt (spreading risk within the banks) were likely to be required with interest rates being 3% to 5% above relevant gilts. Project appraisal and possible levels of toll would be very market sensitive and influenced by the ability to demonstrate that projects were shown to be sound business propositions rather than a good deal for building contractors. The Royal Bank was involved in discussions on the financing of a second Forth Road Bridge and you would not expect me to be specific about these. Nevertheless, it is important that government finds ways of priming the pump in order to start the process of increased private involvement in transport investment. Some government equity in projects could be taken or help could be given through tax-breaks on infrastructure bonds possibly linked with some guarantees of minimum income. Toll bridges had the special advantage that, as in the cases of Dartford and the Severn, existing toll income - and the right to increase tolls to specified levels - could be transferred to a private consortium undertaking to build an additional bridge (or tunnel). This produced a significant income stream to set against borrowing costs.

Mr Middleton's final point was that such means of inducing private finance would only be of overall value to the Scottish economy if they were used to accelerate intrinsically sound projects.

DISCUSSION

Dr Riddington asked for comment on the current problems of raising private finance for rail links to the Channel Tunnel.
Mr. Middleton thought that the government now recognised the need for it to take the lead. He was confident that a substantial stream of private finance would be forthcoming and the sea-change away from the Ryrie rules had helped.

Questions were asked about how to resolve the risk conflict given that motorway tolls were likely to be unacceptable. Mr Watson and Mr Middleton both responded that they did not consider motorway tolls to be unacceptable though, in the shorter term, there might be some use of shadow tolls. Tolls were essential to increase the momentum of private sector involvement and to increase competition within this process. Two participants disagreed that there was any momentum towards tolls and argued that the solution was to increase public spending to take the economy out of recession. Mr. Middleton replied that this view failed to take account of political realities and noted that there was now a unique situation where the marginal cost of government borrowing was presently higher than that for private borrowing. Mr Knight of Taylor Woodrow also added a reminder of the importance of the value of introducing private sector skills. Mr Birt doubted the extent of this advantage

and pointed to improvements within the public sector and to the scope for public/private partnerships.

Professor Thomson referred to the major difficulty of a lack of rail equity and the admitted problems of raising bank finance for a ScotRail management buy-out. Mr. Middleton repeated his view that a 15 year franchise would help but agreed that there had to be concern about the financial implications of the separation of track from operational responsibilities. Mr Kidd (Coopers and Lybrand) asked why vertical integration of track and operations had not been considered in Scotland. Mr. Watson said that this issue had been raised but was contrary to the government philosophy behind privatisation. He felt that the present approach would actually increase rail costs for 5 to 10 years with possible gains thereafter. The immediate worry must be about 'litigation on wheels' and the lack of real improvement.

Mr. Boyle (BR moving to ScotRail) said that the term management buy-out for ScotRail was misleading. Track would remain with Railtrack and a significant number of rail services in Scotland would not come within a ScotRail franchise eg freight services, East Coast Main Line, West Coast Main Line. There was also a definite threat of future government cuts in the funding made available to the Franchise Director with serious implications for Scottish rail services and routes. In these circumstances, it was hard to interest banks in a franchise company. An MBO was the government's preference but it had not been shown that it would work. Mr. Middleton agreed with this assessment unless there were changes in the government's approach. Opportunities for further efficiency gains (as distinct from cuts) in the rail system were limited. Mr. Watson felt that an MBO was probably unfundable in present circumstances. Tony Smith (ScotRail Infrastructure Manager) agreed that infrastructure costs were already at rock bottom. On the Glasgow to Carlisle via Dumfries route, they had been cut from £10,000 a year per track mile to only £2,500 and there was a backlog of essential renewals.

Mr Boyle returned to the problem of lack of certainty about track costs and the suspicion that they would be set at too high a level. Both Railtrack's required rate of return and the valuation of Railtrack assets could be set too high to encourage rail use and reduce pressure on the road network. He also had doubts about how to incorporate effective incentives for improvement within the Railtrack and Train Operating Company form of organisation. Mr. Watson felt that Railtrack would have incentives to increase income from track access charges but this would require a flexibility of approach to charges which might not be allowed under future regulations. There was a risk that savings to meet government financial targets would be made by cutbacks in investment. The continuing lack of a level playing field for road and rail track charges was also a substantial problem, reflecting the lack of a coherent national transport policy.

THE RATIONALE OF PRIVATE FINANCE : PAST PRACTICE AND FUTURE PROSPECTS

Tom Hart, Dept. of Economic and Social History, University of Glasgow

In the morning, Mr Watson had touched on the rationale for private finance but it was useful to place it in a somewhat longer historical context. Mr. Hart proposed to consider some definitions of private finance and to outline four broad phases in the history of public and private financing in transport since the 17th century - concluding by expanding on current world trends and their Scottish implications.

Definitions of Private Finance

On a strict definition, all transport costs could be seen as being met by the private sector. Even on this definition, however, the state had a significant role in determining the tax and regulatory framework affecting transport. There was no such thing as transport free from state influence.

Most transport finance involved a mix of private and public spending (which includes public borrowing from private sources). He would concentrate on the conditions affecting the balance of this mix and the degree to which risk was, and could be, transferred to the private sector.

Historical Phases of Transport Financing

Though timing differed between countries, four broad phases could be detected in relationships between public and private finance in transport. These were:-

1) 17th century to 1830s The initial rise of public sector finance and 'connected' taxation

2) 1840s to 1900s
The Resurgence of Private Finance for both Transport Operations and Infrastructure

3) 1900s to 1980s
The second phase of public sector finance and 'disconnected' taxation

4) 1990s into 21st century
The second phase of private finance and 'reconnected' taxation

In the first era to the 1830s, consciousness of the value of improved transport infrastructure for economic development was growing yet sources of private capital

were often inadequate or commercial incentives lacking to fund major investments. On the other hand, the apparatus of state and local government was strengthening. Hence a substantial rise of public funding for transport infrastructure financed from expanded national and local taxation and public borrowing. In many cases, however, this finance was 'connected' to particular projects and included the rise of road, harbour and canal tolls. Many decisions were within the public sector yet decentralised to a rapidly expanding range of turnpike and harbour trusts.

In the second era covering the remainder of the 19th century, advanced countries such as Britain and the USA had ample private capital to finance transport improvements and a new ability to apply direct, commercial pricing in the rail, shipping and port sectors. Transport could become divorced from taxation (except as a source of taxation, not a use for tax funds). Most road tolls were discontinued though local authorities retained an involvement in local transport.

In developing countries, the state often retained a role but, even here, considerable reliance was placed on direct foreign investment in railways - often with the inducement of a state guarantee of rates of return. More generally, however, this experience of direct state intervention in transport attracted criticism both of the projects selected and of the ability to manage infrastructure schemes after completion. There was a feeling that reliance on the market might produce better results.

The third era, from 1900 to the 1980s, was affected by five factors:-

1) a new confidence in, and political support for, direct state involvement (partly derived from a weakening conviction from the 1870s that the private market always worked well but also influenced by expectations arising from the extension of the franchise to more electors)

2) the apparent inefficiency of competitive private enterprise in transport eg excessive competition in railways and ports seen as damaging to national economies

3) the apparent advantages of public monopoly, economic regulation and transport nationalisation - especially of ports and railways

4) the political and economic difficulties of direct road pricing in a motorising world. There were some examples of a return to road tolls but, since most road traffic was shorter-distance, it was difficult to capture revenue from tolls due to the existence of alternative routes. Governments were attracted to a planned and toll-free strategy for road development encouraging traffic generation and traffic shifts to improved roads

5) the buoyancy of motor transport taxation. Though there were some efforts at taxation 'connected' to road improvements, the vast majority of road taxation - a very buoyant source - went directly to National Exchequers making separate decisions on levels of state funding going to roads and other forms of transport i.e. the rise of 'disconnected' taxation.

The fourth era is one which was now beginning. It has produced renewed interest in private finance, economic deregulation and privatisation for the following reasons:-

- the growing critique of the results of operational monopoly, direct economic regulation and centralisation

- growing budgetary pressures and desires to contain levels of general taxation and public borrowing

- the ability (aided by the electronics revolution) to apply direct road pricing both in congested areas and on major roads and other infrastructure outside areas of congestion

- the emergence of what has been termed the green/gold political and economic alliance opposing the meeting of unconstrained demand for road space and producing a convergence of fiscal, environmental and economic objectives for a sustainable world. This movement has included the rise of fiscal regulation and of road pricing . There was also a revived willingness to appreciate the advantages of 'connecting' taxation and pricing income to regionally based and financed transport and environmental strategies (see G Mulgan, R Murray, 'Reconnecting Taxation', Demos, 1993). Large national and international projects were also been increasingly related to methods of securing substantial elements of risk-bearing private funding.

Prospects

The fourth era discussed above was evident across national and political boundaries; it was set to be a sustained, not temporary, shift in thinking about transport, the economy and the environment. It was unlikely to cease even if, in Britain, there was a shift away from the Conservative governments which have been in power since 1979. Transport now had a different relationship with sustained, economic growth than in the heady years from the 17th century when more mobility was often seen as a cause, rather than a particular effect, of economic growth. What did this new thinking about transport imply for current policies in the UK and the European Union? Six conclusions could be drawn:-

1 sustainable criteria will produce both a rise in road pricing and a significant shift from public towards private investment in transport infrastructure

2 In the absence of road pricing, substantial private investment in the rail sector and creation of a 'level playing field' will require state support for:-
- rail track charges comparable to those on roads
- rail infrastructure costs (financed by diversions from the road budget as part of a national transport policy also making use of tendering as a discipline for cost control and innovation)

3 Substantial increases in private investment in transport will depend on early moves to road pricing and connected taxation(hypothecation) - though with the option for such changes to be used to expand public investment secured on identified sources of income

4 Permit systems should be considered as a means of raising income and reducing congestion in advance of the full application of electronic road pricing

5 Growth of commercial financing and privatised companies is most likely at the inter-regional/international level (with elements of EU grant aid for strategic and peripheral links as in Trans-European Route Networks)

6 At the regional level, there is a need to create regional transport/land use boards with direct responsibilities for transport planning and financing with revenue from reconnected regional taxation and road pricing.

Lastly, some of the immediate Scottish prospects for private finance can be outlined under six headings:-

1 **Forth Crossing** It was doubtful whether private finance would be attracted, at politically acceptable levels of toll, to a second Forth Road Bridge and related approach works at Queensferry. On the other hand, a package of more moderate toll increases could be a means of attracting private finance to provision of a new toll-free Kincardine Bridge, a related road link from south Fife, improved approaches to the existing Queensferry bridge and a range of public transport improvements on the Fife/Lothian corridor.

2 **ScotRail Passenger Franchise** Given a lot of hard work to overcome the problems discussed earlier, it should prove possible to attract private finance to an interim 5 year passenger franchise. The main requirement here will be a government commitment to ensure a level playing field for road and rail

track charges backed, prior to any invitations for franchise bids, by a 5 year programme for capital grants towards infrastructure improvement and rolling stock. This programme could include an airport link in Glasgow and through electrified services from Ayr and from Glasgow Airport to Edinburgh via the planned Crossrail St.Enoch Bridge link in Glasgow

3 **Private Finance in Airports, Ports and Rail Stations.** Continued expansion of private funding was possible in this area with private finance being attracted by pump-priming grants from the new LECs and Scottish Enterprise as well as from local authorities. These packages could also include Light Rail developments in Glasgow and Edinburgh.

4 **Rail Freight and Shipping** Privatised rail freight and existing private shipping was likely to attract extra private investment, especially if rail track charges for freight were to be waived for a 5-year transitional period (with corresponding grants to ensure that shipping - eg from the Forth to continental Europe - was not disadvantaged)

5 **East Coast Rail Passenger Franchise** There was a strong case for a longer franchise - say of 20 years - as part of efforts to encourage rolling stock expansion and route improvement linking with the growth of passenger services though the Channel Tunnel

6 **Internal Ferry Routes** The outcome of current studies of Cal/Mac and P & O services was still not known but one option could be to use a 5 year government programme of capital grants towards new ships and terminals as a lever to stimulate some use of private funding for ferries.

Beyond 1998, private finance could expand further with the widening application of road pricing yet there would also be the alternative path of reconnected taxation and spending via Regional Boards or Trusts. Under the latter approach, private finance could still be encouraged be receiving rights to receive income streams within conditions set by Regional Boards. For trunk transport, UK and EU governmental arrangements were also likely to facilitate mixed funding for major projects.

PRIVATE FINANCE IN SCOTTISH TRANSPORT : A CAUTIONARY NOTE

S R Lockley, Director-General, Strathclyde PTE

The prime focus of policy should be on the needs of people as travellers and as persons affected by movement; financial organisation should be related to this end rather than the securing of private finance being the dominant objective.

Much change had taken place since 1980 and some had been desirable. Despite many drawbacks, bus service deregulation had had the advantage of producing more directed social subsidy. Public taste had continued to reflect strong preferences for car use but there had been some growth of private transport in the form of cycling. Public transport had faced increasing problems yet it had been accepted that fares income often understated the benefits of public transport use, especially in cities.

Public finance was needed to correct defects in the market yet the capital allowance of Strathclyde Regional Council for transport was now half what it had been in the 1970s. Local government reform would also create more road authorities, losing the present advantages of integrating roads, public transport, land use and social policies under one Council. As seen in the morning's proceedings, rail reorganisation had also created major delays in the provision of new rolling stock needed to improve the quality and capacity of Strathclyde rail services. Pressures to use private finance were diverting attention from higher priorities which did not happen to fit criteria seeking increased use of private sector funds.

Buses

Bus operators were rarely willing to invest in infrastructure because of difficulties in capturing gains in hard cash. Similarly rail privatisation could lead to a rundown of stations. Scottish Office and Department of Transport responsibilities inhibited a unified approach to road and rail funding while the huge change of bus service deregulation and the sale of publicly owned bus companies had produced indifferent results. Bus miles had gone up yet patronage and profitability had fallen. There was wasteful provision of empty seats while, at other times, bus services had almost disappeared (apart from a few sustained by social subsidy). There had been some gain from the wider use of minibuses but this had been associated with widening differentials in pay for drivers. The average age of buses had risen since deregulation with many companies lacking the income streams to finance investment in new vehicles. Some operators had widened their choice of tickets yet, though Strathclyde had been able to retain - and expand - Zonecards valid on the great majority of services, ticketing trends had reduced network choice. Total local authority financial support for buses had been reduced since deregulation but this had been accompanied by large cuts in off-peak services. Information was poorer and it had become harder to monitor, and influence, service provision. Bus/rail and bus/bus interchange had deteriorated.

Overall, bus service deregulation had had adverse effects on the industry and on the travelling public. There was an urgent need for a planned network with fixed times for service changes. The approach of the Office of Fair Trading and the Monopolies and Mergers Commission and delays by these bodies in dealing with issues had also hampered a raising of the quality of public transport; presumptions in favour of

competition were too strong and weakened the ability of public transport to emerge as a strong competitor for trips presently, and increasingly, made by car.

The Rail Sector

Rail had seen more efficiency gains than bus services since 1985 but the scope for further gains was now limited. Unlike buses, it had proved possible to maintain the network theme but he doubted whether Mr Freeman's commitment to more modern rolling stock could be delivered without rethinking of present approaches to privatisation.

There had to be concern that new requirements for rates of return, more complex insurance provision, litigation/ consultancy costs, split responsibilities and replacement cost accountancy would raise costs to rail users at a faster rate than road costs. Government now seemed to accept that there would be no short-term financial savings from rail privatisation while most of the alleged benefits were several years away. PTEs had been assured that they would be compensated for immediate increases in costs arising from privatisation but the medium to longer-term position had not been clarified. A whole host of new bodies was now involved in rail issues, raising a real threat of 'litigation on wheels'. On passenger franchises, he felt that 5 to 7 year terms represented the best compromise yet they would increase the workload of the PTE, drawing staff away from other priorities within restricted budgets.

Turning to rail investment, he queried whether train operators would be willing to pay the extra track charges to give Railtrack a commercial return on improvements. This would work against any progress towards sustainable transport unless government stepped in with a substantial and firm programme of investment grants over at least 5 years. The PTE would certainly seek to maintain rail investment in Strathclyde but its boundaries and means of financing after local government reorganisation had yet to be determined. Public finance would continue to be very important for the continuation and improvement of Scottish passenger rail services.

The extension of London's Jubilee line to the Docklands (costing more in total that all urban rail and Light Rail proposals in Scotland) would still attain only a 10% share for private finance. This was also the level of private financing achieved in the Manchester Metro. It was evident that most funding for urban projects would continue to be public funding. One had to ask whether private finance initiatives had been effective when they only produced 10% of funding and, arguably, diverted funding from more worthwhile projects - such as Crossrail in London.

In conclusion, Mr. Lockley accepted that there was some limited scope for private funding in public transport projects (notably in linking decisions on planning applications with contributions to public transport improvement) but the prime need was for a planned public sector framework including substantial injections of public funds. Such a framework did not yet exist but it could open the way to larger contributions from the private sector as part of mixed public/private funding.

PANEL DISCUSSION

(in addition to the previous speakers, the panel included Mr. John Carson of Miller Civil Engineering and Mr David Pollock of the London Docklands Development Corporation)

Mr Pollock felt that private funding was the way forward. Private contributions much larger than 10% would be available for the extension of the Docklands Railway to Lewisham and there were good prospects for private funding of urban roads and combined heat and power projects.

Mr Carson stressed the ability of private funding to help revive a depressed market. The right government framework was important and his firm was already involved in the Skye Bridge and in discussions on the second Forth Road Bridge, a Fastlink from the Forth Bridge to the M6 at Douglas and a West Edinburgh Busway. Mr. Milliken agreed that dormant projects were regaining momentum but actual priorities were puzzling. LEC funds had now been released to provide a rail station at Prestwick Airport yet there were continuing delays on improving the A77 road corridor into Ayrshire. It now seemed that the new A77 would become another welcome example of the design and build approach.

Mr Lockley said that Strathclyde Regional Council was providing 25% of the funding for Prestwick Airport station while the LEC contribution could be seen as public, rather than private, funding. He reverted to his previous point that the search for higher proportions of private funding was often elusive while also diverting public funds from projects offering higher cost/benefit returns.

Mr Middleton added that the aim of the private finance initiative was to increase total funding for transport but Mr Mearns felt that the issue of 'additionality' had not been resolved. It was possible that private funding would only replace reductions in public funding . Increases in total funding might be possible if the Treasury could be persuaded to agree that part of the proceeds of motor taxation would be earmarked for road funding.

Mr Russell stated that, instead of emphasising investment, there should be much stronger efforts to tackle congestion and introduce traffic calming on existing roads.

Mr Birt asked why Strathclyde PTE could not become the direct operator of the Strathclyde rail network. Mr. Lockley agreed that this was an appealing thought but it would require a fundamental change of government attitude. His personal preference was for vertical integration of track and operations.

Mr Middleton disagreed with Mr Lockley's view that private finance distorted investment decisions. It was important to relate capital projects to realistic income streams; moves to road pricing would enhance such streams and improve the quality of decisions. Mr Pollock added that cost benefit studies meant little to the private sector; what mattered was the ability to get projects going through involving wider sources of funding.

Mr Lockley replied that advances could be made by easing the rules for public borrowing while also introducing urban road pricing. On these conditions, the public sector could respond without any need for significant alliances with private funding.

This led into a discussion of current Scottish Office studies of ferry operation. Dr Riddington said there was no necessary logic in privatisation being the way forward. On efficiency criteria, the publicly owned Cal/Mac performed better than P&O services so government ought to be thinking of extending the Cal/Mac approach to the trunk ferries to Orkney and Shetland. Public ownership should be extended, rather than narrowed.

Mr Pollock considered that this approach was out of tune with current thinking. There was wide support for a change of balance away from public funding. This did not mean an inactive government role. Government needed to be pro-active in creating a framework favouring increases in private financing. The Department of Transport had been slow to adopt such a role but he felt that the Scottish Office was already more pro-active - especially in relation to the road programme. Mr Carson added that the proof of this was to be found in work proceeding on the Skye Bridge and in goverment initiatives towards a second Forth Road Bridge.

SUMMING-UP

As Conference Chairman, Mr. Hart drew the discussion to a close and made two concluding comments:-

1 rail privatisation had generated a substantial amount of conflicting comment. Some of those attending had opposed the entire concept but the greatest criticism had centred on the practicality of the present arrangements. Government would need to give attention to means of making rail reorganisation more effective within a 'level playing field' policy for transport

2 though sustainable transport had become an important issue, the confereence had generated little discussion of the relationships between sustainability and private finance. One view was that private finance could be used to increase total transport investment and mobility while the alternative view had stressed the role of private finance and direct pricing as means of restraining unsound projects and traffic generation. Resolution of these tensions was bound to be a matter for further debate and decision-taking within strategies for sustainable development.

The Chairman then invited the principal speakers to make their own final comments. Mr Middleton was bullish about the prospects for private finance in Scotland but felt that the framework still needed to be strengthened with public funding being used to pump-prime an expansion of private sector involvement in transport. Mr Watson said that there was a danger of the tail wagging the dog. One had to go beyond creative accountancy to a situation where private finance was increasingly attracted to projects worthwhile to the economy as a whole. Mr Lockley reiterated that there was a need to find bridges between commercial and public service approaches. There should be less shifting of goals by government and greater clarity of aims. He welcomed the recent decision not to proceed with bus service deregulation in London and added that the logic of this needed to be applied in other cities. Provided that there was a clear and politically acceptable clarification of the incidence of risk in future projects, it was possible that the role of private finance could be increased without prejudice to wider social and economic objectives.