Britain's Rail Freight Privatization — An Investor's View

RAIL FREIGHT CONFERENCE • LONDON • JUNE 1995

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What I would like to talk about today is our view of the British Railway Privatization. First I will compare the UK privatization on a structural basis with the rest of the world as we see it; second, I will compare the fundamentals of the UK privatization with the rest of the world; third, talk about how to value railway freight franchises; fourth, how to structure for competitive advantage, not only in making successful bids but also in making sustainable bids; fifth talk about possible roles for US investors in the UK; and then close with some conclusions.

Global Perspective on UK Privatization – Structure

Taking the major types of privatization and the major countries where it's evolved, please focus your attention on the franchise type and note that in the USA, Argentina and New Zealand the franchises are all exclusive and these have all been considered successful. In Chile, they have a kind of open access and there was only one bidder. In the UK, a grand experiment is about to begin and it will be very interesting to see how many bidders come forth, but I think more importantly how successful these privatizations will be. I'm confident there will be numerous bidders but the question is, "Are these sustainable bids or not?" I think a lot of that is driven by the type of franchise, which I will clarify later on.

Rail Privatization Models (freight only)

	USA	Argentina	Sweden	New Zealand	UK	Chile
FRANCHISE SCOPE	Region	Region	Branches	Country	Country	Region
NUMBER OF FRANCHISES	1	6	Unlimited	1	6 Initially	1 Initially
FRANCHISE TYPE	Exclusive	Exclusive	Open Access	Exclusive	Open Access	Open Access
TRANSACTION YEAR	1987	1991-Present	1988-Present	1993	1996? and beyond	1995
INFRASTRUCTURE TRANSACTION	Purchase	Lease	Utilization Fee	Purchase	Utilization Fee	Utilization Fee-Core Lines; Lease-Branch Lines
INITIAL ROLLING STOCK TRANSACTION	Purchase	Lease	Purchase	Purchase	Lease	Purchase
ONGOING SUBSIDY	None	None	As needed	None	As needed	None
EXAMPLE	Conrail	BAP	Osterlentag	NZRL	Load Haul	FEPASA

Primary Government Objectives

	USA	Argentina	Sweden	New Zealand	UK	Chile
REDUCE / ELIMINATE LOSSES	X	X	X		X	X
IMPROVE SERVICE / LOWER TRANSP. COSTS		X			X	X
RAISE CASH	X	X		X		X

Global Perspective on UK Privatization – Fundamentals

Taking a simplistic approach, there are really two main elements of what drives success in business. One is revenue, and the other is costs and I would submit, based on the experience in the USA and Argentina and other countries, revenue is more important than costs. I know that railways have historically been cost focused, but if you look at why railways have failed in our country and other countries, it's usually been due to revenue shortfalls, not cost overruns. The reason is that you can't control your revenue nearly as much as you can control your costs, especially when you're serving smokestack industries that are declining. Let's examine the three elements of revenue: Competition, Market Share and Traffic Base.

		USA	New Zealand	Latin America	UK
REVENUE:	COMPETITION	Other RR	Truck, Shipping	Truck	Other RR
	MARKET SHARE	Mature	Mature	Low	Mature
	TRAFFIC BASE	Mature	Mature	Expanding	Mature
COSTS:	INFRASTRUCTURE	Good	Excellent	Fair	Excellent
	ROLLING STOCK	Good	Excellent	Poor	Good
	STAFFING	Low	Low	High	High
	RAILWAY CAPITAL MARKETS	Mature	Mature	Emerging	Emerging

In the USA the main competition is between railroads. The market share is mature in that we hope to get more market share but it's not going to be double-digit improvement; it's going to be single digit improvements if we are extremely successful. The traffic base that we serve is mature. There are no major structural changes awaiting us in the US market that we can foresee. In Latin America, by contrast, the competition is only truck because for example, we are the only railway that runs from Brazil to Argentina. The market share is low because when these railways were privatized they had basically stopped operating, so there is no place to go but up. The traffic base is expanding. If you've read anything about the economy in the southern part of South America, there's a lot of good news coming out as industries restructure and take more of a foothold in the global economy. By comparison, in the UK the competition will be other railways. It will be more competitive than the USA, because in the USA other railways compete on their own separate tracks so they have different cost and service characteristics. The Iowa Interstate is one of four railways between Chicago and Omaha, but we're responsible for our own infrastructure and we have different cost characteristics. In the UK, my understanding of open access is that everybody will have the same track costs. They're using the same infrastructure plus or minus what you can negotiate with the Regulator. In terms of market share, it's relatively mature. Yes, there is the prospect of intermodal and there are anecdotes about growth in traffic but relative to what we see in Latin America it's a relatively mature market. The traffic base is more or less mature.

On the cost side I would say that we are in very good shape in the US. We have good infrastructure, good rolling stock, lean staffing levels and mature railway capital markets that allow us to reinvest because we have the markets for equity and debt that it takes to bootstrap ourselves into better shape. In Latin America, the railways are generally in poor shape, they require investment, the capital markets are just emerging but I would rather have a cost problem than a revenue problem. We can manage our way out of it. In the case of the UK, there is an excellent infrastructure, good rolling stock, relatively high staffing levels, and emerging railway capital markets. It's a mixed bag, but my focus is more on revenue than on costs. So I would say relative to other parts of the world, the structure of the UK privatization has a lot of problems. Again, relative to other parts of the world.

Valuing the Freight Franchises

How do you value a freight franchise? I'll begin by making a controversial statement, "Under Open Access a franchise is not a franchise at all, because you have intramodal competition, that is rail versus rail, which is likely to minimize profit margins once Open Access takes hold." I've been spending a lot of time the last couple days asking people to please tell me I'm wrong. Tell me that the customers will not insist that each of the trainload freight companies bid against each other for each contract as it rolls over. I haven't heard anything that eliminates that concern. I'd also make the point that despite the mature markets, revenue projections are going to be more risky going forward given the unknown structural impact of Open Access. What is the timing of when the contracts rollover, and how opportunistic will the customers be in terms of forcing your pricing down to breakeven levels? The only analogy I can come up with for what is about to happen in the UK is the US domestic airline industry, which is the best model of Open Access. You've got the prospect of the same competitive and financial results awaiting, unless I'm wrong.

To summarize:

- Under Open Access, a Franchise is NOT a Franchise.
- Intramodal Competition (Rail vs. Rail) is likely to minimize profit margins as Open Access takes hold.

- Despite mature markets, revenue projections are highly risky due to unknown impact (timing, severity) of major structural change (Open Access).
- The US domestic airline industry is a model that Open Access may force on the UK—with the same competitive and financial results.

Structuring for Competitive Advantage

1. **A Motivated Seller**
2. **Local Partners**
3. **Commitment / Flexibility**
4. **Cultural** (language, social, psychological)
5. **Business** (structure)
6. **Marketing** (revenue)
7. **Technical** (costs)

What really makes privatization work is a motivated seller, followed by strong local partners, followed by commitment and flexibility, and finally the ability to bridge cultural gaps and work together in a good business structure. Now, in the particular case of the UK I am firmly convinced that the seller is motivated. This is an unstoppable process; the train is leaving the station and it's just a question of who's going to be on it.

In terms of local partners, there is no question that there are plenty of savvy venture capital firms in the UK and plenty of experienced railway managers. So that's not a concern. There's a commitment and flexibility that I sense in terms of people genuinely committed to bidding. The cultural elements are where groups often fail and I think that it's seductive to believe that just because we speak the same language that we don't have a lot of potential for misunderstandings. I know that in our bid for New Zealand it was not until months and months into the process that we really got to know our partners and understand what great business people the Kiwis are. I have never met a more savvy, competitive, hard-charging bunch of people in my life. I think a lot of that has to do with their being in an isolated location and being very good at trading. We as a country tend to be very insulated because we are so big; a lot of us don't even have passports. So, when you get down to the bottom, you see marketing and technical and the kind of things that are more railway skills than the points at the top. But let me stop de-emphasizing the value that an overseas partner brings and say that you also need railway skills—railway skills that are a different perspective perhaps than what has traditionally been seen.

Roles for US Investors

High Value

MARKETING:	Anticipation of structural change to markets, competition
FINANCING:	Well-developed railway equity and debt markets
INTERCARRIER RELATIONSHIPS:	Cooperation with European carriers, inter-UK routings
EQUITY INVESTMENT	

Let me talk specifically about roles for US investors and how I think the privatization here would play out. I see a high value in US participation due to our experience in marketing. We've been through deregulation in our country. It's been an expensive process, a lot of people have lost a lot of money and there are many lessons learned, not all of which are translatable to the UK, but some are. For financing, we have a well-developed railway equity and debt market in our country; again, some elements of which are translatable to the UK, and some are not. In terms of intercarrier relationships, we have a well-developed system of interchange between carriers and the biggest complaint you'll hear our customers give us is that two railroads can't agree on price, service, equipment and it's not a seamless connection. We are making progress, but we're not there yet. And of course another value is equity investment.

Low Value

OPERATIONS:	UK environment different, much more regulated
ENGINEERING:	UK expertise second to none
LABOR RELATIONS:	US environment different, much more regulated

What I would put a low value on, however, is in the areas of: operations, engineering and labor relations. The UK's operating environment is much different than in the US; it's much more regulated and the type of expertise that we have would not have a lot of value. In the engineering area, you've built the world's railways; there is nothing that you really have to learn from anybody in the engineering area. Last, in the labor relations area, I would submit that our environment is much different in that the US is more regulated than the UK. We have a very convoluted, unusual, distorted labor relations environment in the US which has no parallel any place I've ever been.

Conclusions

- A rational investor is unlikely to pay a high price or have significant capital at risk unless the business is a Franchise.
- The main benefactors of Open Access will be rail customers, not train operators, because the customers will insist upon pervasive competition.
- Every deal is a good deal at the right price, meaning capital should be available at the right price.
- Overseas investors should be interested at the right price and most importantly with the right partners. We could be involved with anyone as long as in the structure we add a genuine value. I am very enthusiastic about the UK, and I want to emphasize that every deal is a good deal at the right price. How we have survived in our business is by not overpaying and I think that's a difficult temptation to avoid.

Thank you.

Questions & Answers

Q: One very basic theme for British Rail, the many freight companies that operate in Britain and in Argentina, and Wisconsin Central in New Zealand is that in Britain we have primarily a passenger railway with full compliance in terms of safety standards and regulation, whereas the other three are primarily freight railways where there is the odd passenger operation. Would you comment on the differences with respect to how you feel you might be constrained or limited in Britain in trying to operate the freight service over tracks that were primarily occupied by and designed for passenger service?

A: I don't see that that really has any impact of significance on the ability of freight to prosper. The main concern I have with the way the privatization is structured has nothing to do with costs, and it has everything to do with revenue and that is rail vs. rail competition. It is quite common for freight railways to operate over passenger lines. For example, we do that to get into Chicago, and Conrail operates over Amtrak on the high-speed Northeast corridor. That is the kind of thing that operating people can work out at the local level as long as there is a commitment to working together.

Q: One of the reasons for the poor figures of the Freightliner at the present time is the very poor productivity in the train crews. I believe I've seen that the average engine driver in this service averages 45 miles a day. What total figures would you expect to get from your railway operation in the US?

A: In terms of the typical productivity of a train crew, my guess is that on Iowa Interstate we would get about 200 miles in a single day from our crews.

Q: I was intrigued by your comment that the main threat for competition in the UK is rail vs. rail as opposed to trucks despite the loss of traffic to road over the years. Would you please discuss further?

A: I think that the job of the transportation department at British Steel is to minimize your transportation costs, and I think that you're doing your stockholders a disservice if you don't do that. What you need to do is to take advantage of every possible opportunity to minimize your transportation costs. To the extent that you can bring three trainload freight operators in, plus an electric utility that is going to get its own train and have some excess capacity on the back of a train, and offer them your business, winner takes all, you will get them to cut each other's throats. And then you will win and they will breakeven if they are the successful bidder.

Q: First, the competition between freight companies has been discouraged prior to the sale, naturally; we've been aware of that. Secondly, and more importantly, a single purchaser has not been ruled out so I come back to your point that there might not be any competition as you contemplate.

A: My response is that if there is a single buyer for the three trainload freight businesses, the likely result would be that at least one Open Access operator would enter the market.

Q: Can you tell me whether the growth in America has been due to reclamation of previously lost shares of the bulk market or whether you might have made any inroads into the previously untapped potential in the FMCG market (consumer goods) and it was the thought that as you gain potential in that market that revenue would grow?

A: We have done both. In the case of boxcar traffic, which we lost over the years to truck, a certain amount of that we have recaptured at lower margins through intermodal. In the case of bulk traffic, we have improved our position by becoming more efficient on short-distance traffic. We are trying to convert some of our intermodal business to boxcar business. When you get away from private siding business and bring your customers into using intermodal terminals, you're really teaching them how to use trucks because you need to get it into a truck to get from the customer to the intermodal terminal. If it's in a truck, why not take it all the way? I am a big fan of what has been long looked down upon in the US, which is so called loose car railroading. I think that there is more profit to be made in it; it is also a more rewarding business.

Q: This is related to your last point on the difference between intermodal and the boxcar. What is fundamentally different in the UK is actually just that—the lack of rail private sidings. If you take a private siding building and you have to have your own private collection siding and you instead just use the rail hub, some people think that's exactly why the boxcar won't work. It is very much a way of looking at things—the configuration of the customer's total cost as well as the rail station.

A: I agree.

[END]