Parasitic bodies

The business model of the private train operating companies who are wrecking our railways

RMT report

July 2023

Introduction

The private train operating companies who are currently closing ticket offices, cancelling services and sitting back, counting their money while the government bankrolls their hard line in the rail dispute are also a little nervous about the fact that their business model is under scrutiny as never since the railways were privatised.

So they should be, because the truth is that for all their buccaneering talk about investment, innovation and competitive spirit, the Train operating companies have got away with daylight robbery since 1997.

In this report, we highlight:

1. The fact that the train operating companies have invested almost nothing in the railways, depending on public sector investment to fund improvements;
2. The fact that the Train Operating Companies have profited handsomely out of privatisation while putting very little in, making returns of around 120% on the capital they invest;
3. The fact that the vast majority of those profits – 65% - have been taken out of the railways in the form of dividends.

1. Between 2006 and 2022, the train operating companies invested just 1% of the money spent on the railways

The stark fact is that public investment in rail has dwarfed private sector spending since privatisation.

Public spending has surged over the period since privatisation. On average over the last 15 years, the private sector has contributed just 8% of what government spends. 76% of that 8% is spent on rolling stock by the ROSCOs and as we've shown before, even this supposed spending on rolling stock has been mainly subsidised by government funding. Franchise subsidies have risen in the last decade in large part to cover the rising costs of rolling stock. As the authors of Rebuilding Rail say, 'while technically considered as private expenditure, this is underwritten by franchise contracts which are only rendered financially attractive by the public subsidy to Network Rail and in most cases a public subsidy to the TOC that will be leasing the trains'.[1]

Spending that is actually attributable to the TOCs amounts to **1.1% of total expenditure** on the railways, equivalent to **1.8%** of what is spent by government each year on average.

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[1] *Rebuilding Rail: Final Report 2012*, Transport for Quality of Life, 2012, p. 33.

Table 1: TOC spending as a proportion of total spending[2]

(£m)	Total railway expenditure	Spending attributable to the TOCs	
Apr 2015 to Mar 2016 [b]	18,037	200	1.1%
Apr 2016 to Mar 2017	18143	175	1.0%
Apr 2017 to Mar 2018	18513	283	1.5%
Apr 2018 to Mar 2019	20378	265	1.3%
Apr 2019 to Mar 2020 [b]	21101	214	1.0%
Apr 2020 to Mar 2021 [r]	21916	217	1.0%
Apr 2021 to Mar 2022	22768	225	1.0%
			1.1%

While the private train operating companies don't like to talk about this in front of the wider public, it is something they actually boast about in front of their shareholders.

For example, in 2019, FirstGroup CEO Matthew Gregory reassured his investors that franchising involved little capital expenditure: "As we have said before, the capital expenditure in Rail is normally funded through the franchise payments or through third-party capital grants. The investment in Rail CapEx is usually using someone else's cash." In their February 2022 trading update, FirstGroup said: "First Rail continues to be cash capital-light, with any capital expenditure required by the four management fee-based operations fully funded under the new contracts."[3]

This has always been the case throughout privatisation. As the ORR noted over 10 years ago 'TOCs tend to be thinly capitalised companies with few assets and relatively little ability to bear downside risks. To help manage this issue, revenue risk-sharing mechanisms were introduced into franchise contracts'.[4]

In addition, the TOCs are insulated from the full costs of operating, maintaining, renewing and enhancing the rail network by massive grants to the publicly owned Network Rail. These subsidies – network grant – are given in return for Network Rail keeping its track access charges to the TOCs artificially low. As the ORR noted in 2012, "the industry as a whole remains heavily subsidised….if Network Rail were to cease to receive [network grant] and instead rely on revenue generated by track access charges then all TOCs would require a positive, significant subsidy'.[5]

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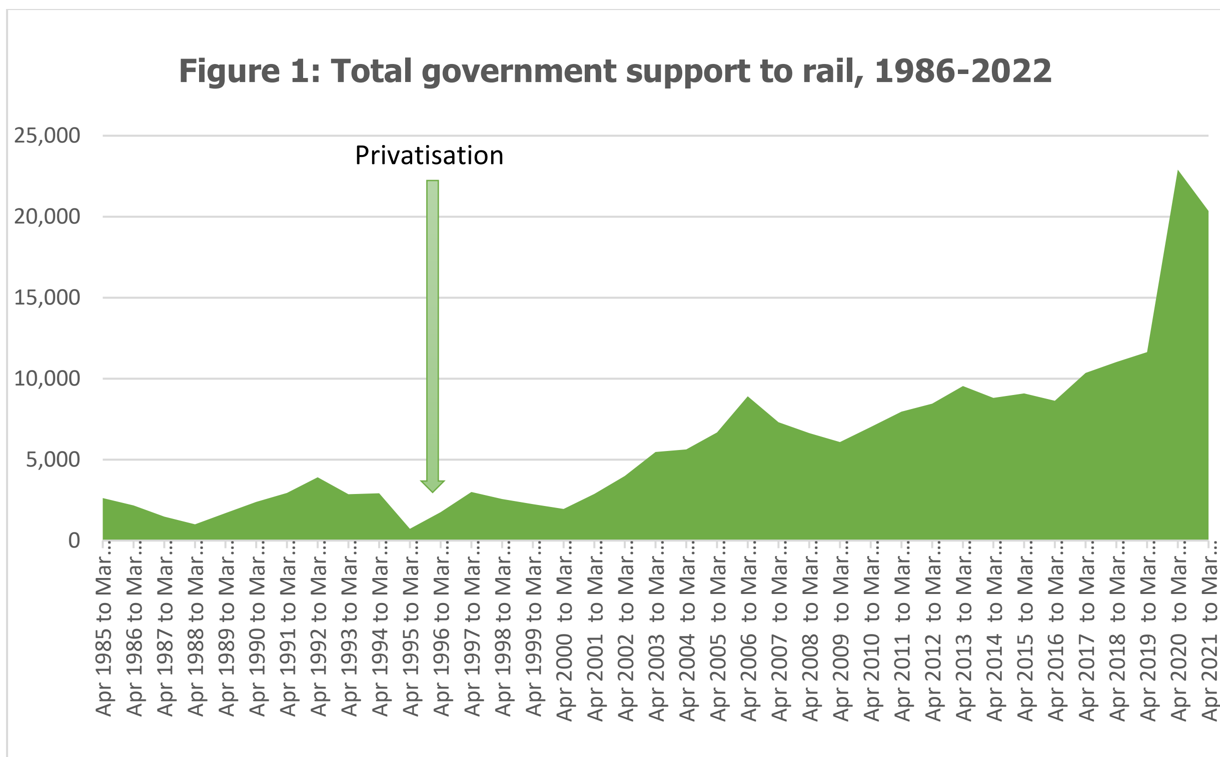
[2] https://dataportal.orr.gov.uk/statistics/finance/rail-industry-finance/table-7210-uk-rail-industry-finances-since-2015-16-by-country-and-nr-region/

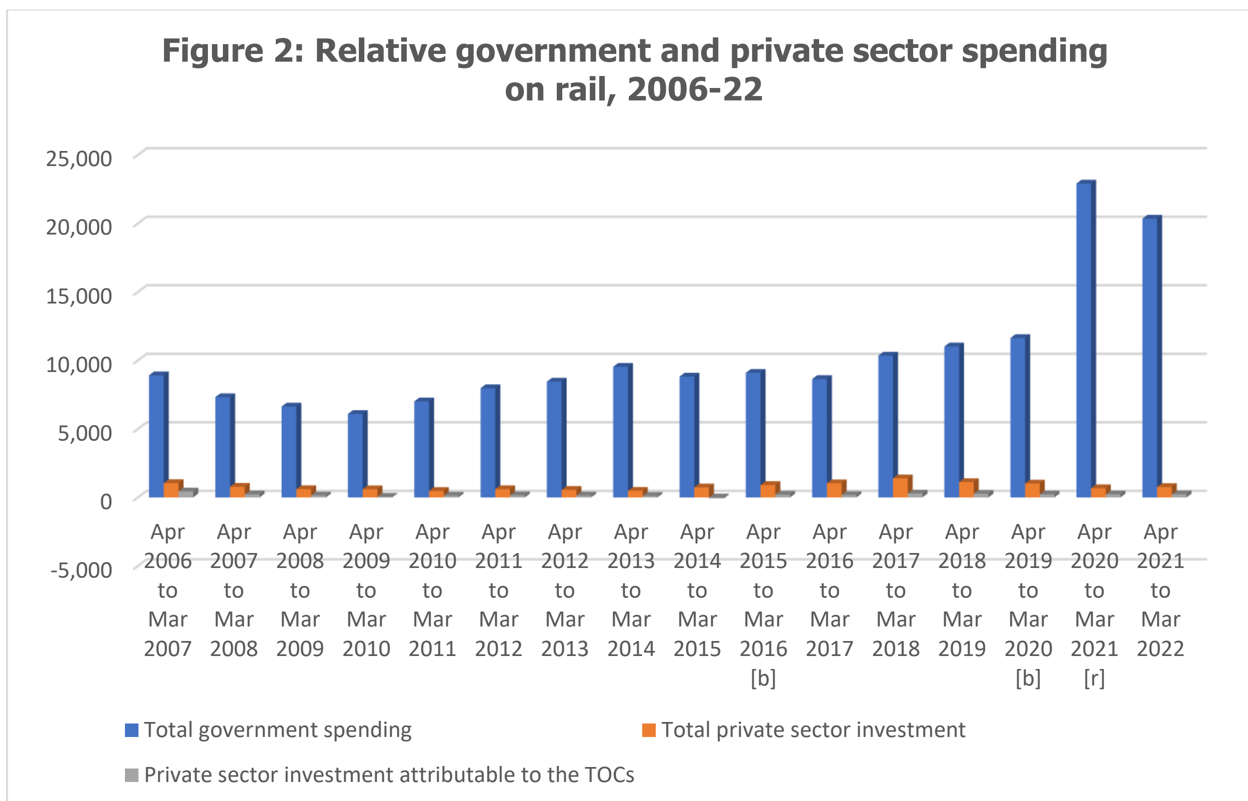
[3] https://www.firstgroupplc.com/~/media/Files/F/Firstgroup-Plc/reports-and-presentations/presentation/fy-2021-22-results-presentation.pdf p. 13.

[4] Office of Rail Regulation, *Costs and Revenues of Franchised Passenger Train Operators in the UK* (November 2012), p. 16.

[5] ORR, *Costs and Revenues of Franchised Passenger Train Operators,*, pp. 21-22.



Source: https://dataportal.orr.gov.uk/statistics/finance/rail-industry-finance/table-7270-government-support-to-the-rail-industry/



Source: https://dataportal.orr.gov.uk/statistics/finance/rail-industry-finance/table-7270-government-support-to-the-rail-industry/ https://dataportal.orr.gov.uk/statistics/finance/rail-industry-finance/table-7290-private-sector-investment-in-the-rail-industry-excludes-network-rail-investment/

Table 2: Government and private investment in rail[6]

(m)	Total government spending	Total private sector investment	Private sector as a % of government spending	Investment attributable to the TOCs	TOC investment as a % of government spending
2006-2007	£8,915	£1,045	12%	£438	4.9%
2007-2008	£7,317	£779	11%	£216	3.0%
2008-2009	£6,636	£603	9%	£142	2.1%
2009-2010	£6,093	£597	10%	£53	0.9%
2010-2011	£7,009	£472	7%	£129	1.8%
2011-2012	£7,969	£604	8%	£159	2.0%
2012-2013	£8,451	£551	7%	£135	1.6%
2013-2014	£9,534	£484	5%	£115	1.2%
2014-2015	£8,815	£734	8%	-£76	-0.9%
2015-2016	£9,094	£906	10%	£200	2.2%
2016-2017	£8,641	£1,035	12%	£175	2.0%
2017-2018	£10,350	£1,393	13%	£283	2.7%
2018-2019	£11,018	£1,120	10%	£265	2.4%
2019-2020	£11,632	£1,013	9%	£214	1.8%
2020-2021	£22,905	£672	3%	£217	0.9%
2021-2022	£20,346	£762	4%	£225	1.1%
TOTAL	£164,725	£12,770	8%	£2,890	1.8%

[6] https://dataportal.orr.gov.uk/statistics/finance/rail-industry-finance/table-7290-private-sector-investment-in-the-rail-industry-excludes-network-rail-investment/ ; : https://dataportal.orr.gov.uk/statistics/finance/rail-industry-finance/table-7270-government-support-to-the-rail-industry/

2. TOCs take little risk with their capital but get a great return: Profits represent 126% of the capital invested by the train operating companies

The train operating companies like to stress how small their profit margins are. Before the pandemic and the changes in contracts, they liked to estimate their returns at 3%. Now, under the variety of emergency contracts and National Rail contracts they've signed with the government, the TOCs stress their '2%' return. This is measured as 'Return on Sales (ROS), profits as a proportion of revenue.

But matters look very different if we look at the rate of profit measured against the capital they put up.

Investors use the measure of Return on Capital Employed (ROCE) to measure the return against the 'risk' taken by businesses in investing capital. ROCE is measured by dividing the profits before tax by long-term capital invested, or 'capital employed'. Capital employed is calculated by subtracting current liabilities (money the company owes within one year) from the company's total assets.

As one academic study has argued, 'like many other outsourcing businesses, train operating requires very little capital investment, so that a modest return on sales turns into a starry ROCE'.[7]

As we've seen, the TOCs are proudly capital-lite entities who invest very little in the railways (at least when they're talking to shareholders). As we'd expect, their company accounts show that their Return on Capital Employed (ROCE) is very high. For the period between 2013 and 2022, the average Return on Capital Employed was 126%. This is comparable with the findings of the academic study mentioned above which studied TOCs' ROCE in 2010-12 and found that the average ROCE in this period was 121%.[8]

In other words, the TOCs' have never put up much capital, and never taken much risk but they've got a great rate of return on the money they did put up.

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[7] Andrew Bowman, Ismail Erturk, Peter Folkman, Julie Froud, Colin Haslam, Sukhdev Johal, Adam Leaver, Michael Moran, Nick Tsitsianis, Karel Williams, *What a Waste: Outsourcing and how it goes wrong* (Manchester University Press 2015), pp. 43-47.

[8] Ibid, pp. 47-48.

Table 3: Rate of return on capital employed for Train Operating Companies

Return on Capital Employed (ROCE	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	10Y Ave
Chiltern	-6%	13%	-1%	-9%	18%	6%	1%	-21%	2%		0%
Cross Country	60%	41%	22%	43%	82%	96%	73%	24%	13%		51%
Essex Thameside		121%	36%	96%	637%	86%	-15%	88%		379%	178%
East Midlands	46%	55%	1755%	133%	67%	71%	272%	63%	19%	22%	250%
Great Western	59%	40%	205%	158%	103%	165%	357%	56%	30%	111%	129%
Greater Anglia	2%	68%	76%	314%	105%	12%	2%	-211%	218%	5%	59%
London Midland/West Midlands	8%	-67%	12%	24%	106%	37%	94%	-68%	186%	5%	34%
Northern	781%	561%	3397%	101%	38%	18%	967%	27%	125%		668%
South Western	53%	68%	59%	45%	48%	119%	452%	2%	-230%	39%	65%
Southeastern	11%	24%	40%	56%	77%	72%	65%	30%			47%
Thameslink Southern Great Northern			-470%	-42%	11%	6%	2%	21%	43%	15%	-52%
Transpennine	59%	119%	66%	65%	117%	0%	-26%	-38%	747%	46%	115%
West Coast	91%	38%	119%	140%	122%	111%	82%	70%	99%	78%	95%
AVERAGE											126%

Calculated from Company Accounts for the contracting companies for each franchise.

3. Laughing all the way to the banks: 65% of profits disappear into shareholder dividends

The final nail in the idea that the train operating companies have brought new investment to the railways is the fate of the profits that they make.

Totalling up the profits before tax for the train operating companies for each year since 2015-16 and comparing them with the dividend payments they declared to the Office of Rail and Road, we can see that on average 65% of all the profits before tax made by the TOCs is disappearing out of the industry into the pockets of the owning groups and from there being siphoned off by greedy City investors or foreign state-owned companies to subsidise their own passenger fares.

In summary, these companies put almost nothing into the railways in terms of investment, typically make returns far above their investment and then funnel most of that money out of the railway industry.

Table 4: Profits before tax and dividends – Rail franchises[9]

	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	Average
Profit before tax	284.7	310.6	245.1	291.3	86.4	611.7	239.8	295.6
Dividends paid	218.1	204.8	207.3	189.4	169.1	252.7	108.3	192.8
	77%	66%	85%	65%	196%	41%	45%	65%

[9] Source: profits before tax calculated from Company Accounts 2015-16 to 2021-22 and dividends from the Office of Rail and Road: Table 7226 – Franchised Passenger Train Operator Finances since 2015-16 by Franchise | ORR Data Portal- https://dataportal.orr.gov.uk/statistics/finance/rail-industry-finance/table-7226-franchised-passenger-train-operator-finances-since-2015-16-by-franchise/ The dividend figures were calculated for the same sample of TOCs: Chiltern, Cross Country, East Midlands, Essex Thameside, Govia Thameslink, Greater Anglia, Greater Western, South Eastern, London Midland/West Midlands, Northern, South Western, Transpennine, West Coast.

Table 5: Profits before tax – Rail franchises

Profit before tax	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22
Chiltern	-3.6	7.1	3.3	0.8	-5.3	1.6	
Cross Country	15.1	28.6	29.5	35.1	10.4	6.2	
East Midlands	31.4	25.3	19.3	22.5	25.0	9.4	6.5
Essex Thameside	9.2	-10.9	-6.5	-22.4	-10.1		142.2
Thameslink, Southern, Great Northern	-15.6	4.9	3.7	1.0	22.2	49.8	18.7
Greater Anglia	21.7	19.4	6.0	1.7	-57.6	291.0	3.2
Greater Western	56.8	48.1	44.1	56.0	54.8	39.9	31.0
London and South Eastern Railways	38.6	42.5	52.9	59.5	25.5		
London Midland/West Midlands	9.3	35.1	7.4	41.4	7.3	105.2	5.7
Northern	17.0	21.0	12.7	41.8	4.1	-11.6	
South Western	20.1	16.1	8.6	8.1	-1.1	31.5	12.3
Transpennine	17.7	7.1	0.1	-7.1	-3.5	72.2	8.0
West Coast	67.2	66.1	64.0	52.8	14.6	16.6	12.3
TOTAL	284.7	310.6	245.1	291.3	86.4	611.7	239.8

Table 6: Dividends proposed and paid 2015-22[10]

Dividends proposed and paid (£m)	Apr 2015 to Mar 2016	Apr 2016 to Mar 2017	Apr 2017 to Mar 2018	Apr 2018 to Mar 2019	Apr 2019 to Mar 2020	Apr 2020 to Mar 2021	Apr 2021 to Mar 2022	TOTAL
Chiltern	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Cross Country	0.0	0.0	0.0	26.6	25.1	12.5	0.0	64.2
East Anglia	0.0	57.1	10.3	1.1	0.8	1.0	0.0	70.3
East Midlands	11.3	0.0	38.1	26.6	16.7	0.0	19.9	112.6
Essex Thameside	0.0	0.0	0.0	4.3	0.0	0.0	0.0	4.3
Great Western	44.1	33.6	43.5	53.2	61.7	0.0	33.0	269.1
Northern	22.4	0.0	0.0	2.1	0.0	0.0	0.0	24.5
South Eastern	55.4	11.2	32.6	31.9	31.4	0.0	30.0	192.6
South Western	0.0	50.3	0.0	0.0	0.0	0.0	12.9	63.2
Thameslink, Southern and Great Northern	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Transpennine	22.6	0.0	0.0	0.0	0.0	0.0	0.0	22.6
West Coast	62.2	52.6	55.5	43.6	33.5	11.7	12.5	271.6
West Midlands	0.0	0.0	27.2	0.0	0.0	0.0	0.0	27.2
TOTAL	218.1	204.8	207.3	189.4	169.1	25.3	108.3	1,122.3

[10] https://dataportal.orr.gov.uk/statistics/finance/rail-industry-finance/table-7226-franchised-passenger-train-operator-finances-since-2015-16-by-franchise/

Appendix: Methodological note on calculating ROCE

ROCE is calculated by dividing the profit before tax by the 'capital employed'. Capital employed is calculated by subtracting current liabilities from total assets.

The calculations of ROCE for these franchises were conducted using the published Companies House accounts for the various companies who have contracted with the DfT for the following franchises: Chiltern; Cross Country; East Anglia; East Midlands; Essex Thameside; Great Western; Northern; South Eastern; South Western; Thameslink, Southern and Great Northern; Transpennine; West Coast and London Midland/West Midlands. Scotrail and Wales and Borders were omitted as were the predecessors to the Thameslink, Southern an Great Northern franchise.

The analysis was straightforward for the pre-pandemic period and revealed a higher ROCE of 146%. The pandemic muddied the picture somewhat. Obviously, some profits before tax were affected, but this was moderated by the fact that the TOCs had revenue risk taken off them and were placed on management contracts. More important for the calculating of ROCE were two things that happened at around the same time.

Firstly, a number of companies were in negotiations with the DfT over the terms of their exit from their current franchises and transferring onto new contracts. As they did this, they registered 'onerous contract provisions' which were essentially estimates of their potential losses if they had to pay compensation to the DfT for exiting the franchise and moving onto a new contract. In reality the sums agreed with the TOCs were invariably far smaller than the provisions made in the 'onerous contract' charges but these were registered to both the profit and loss accounts and to the balance sheets artificially affecting both. These have been discounted for the purposes of calculating the ROCE.

The second thing that happened - almost simultaneously - was a change in accounting standards associated with IFRS 16 which prompted some TOCs to account differently for their rolling stock leases. From 2020, these 'right of use assets' were placed on the TOCs' balance sheet in spite of the fact that this was simply recording money moving through the TOC's accounts in the form of payments from the DfT to the ROSCOs. This had the effect of artificially inflating the TOCs' balance sheets with assets they could use but did not constitute real assets. The TOCs also recorded liabilities for their payments to the ROSCOs but because of the length of the leases, much of the liability fell into the category of 'non-current'. Because ROCE is calculated by subtracting current liabilities from total assets, the effect of this on some TOC balance sheets was quite marked with 100s of millions in 'right of use assets' appearing in their assets and only a portion of the liabilities being recorded as 'current'. In order to mitigate the distorting effects of this, for the purposes of calculating ROCE, we have subtracted the rolling stock 'right of use assets' from the assets and the rolling stock lease liabilities from the current liabilities and recalculated ROCE on this basis.