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Privatization of Rail and Tram Services in Melbourne: What Went Wrong?

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ABSTRACT *Melbourne's urban rail and tram systems were privatized in 1999 using a concessioning or franchising model similar to that employed for British Rail in the 1990s. The Melbourne franchise agreements promised improved services, increased patronage, reduced government subsidies and no real increase in fares. However, within 2 years, it became apparent that these predictions had been over optimistic, and subsequent negotiations saw the departure of one of the three franchisees and a renegotiation of agreements with the remaining two operators leading to substantial increases in subsidy levels. The paper reviews the Melbourne privatization experience to assess the extent to which it has produced benefits, the reasons the original predictions were not met and the extent to which the problems were avoidable. It concludes that although the Melbourne franchises were expressly designed legally to transfer revenue risk to the private operators, they failed to achieve this as a matter of practicality.*

Introduction

Following the poor performance of bus systems in UK cities outside London (Mackie *et al.*, 1995; White, 1997), few commentators now advocate deregulation of urban public transport, but there remains debate about the best ways of bringing competitive forces to bear. A number of analysts have evaluated organizational frameworks for public transport by categorizing the planning process as one performed at three levels: strategic, tactical and operational (Van de Velde, 1999; Hensher and Macario, 2002). In the case of bus services in London, Copenhagen, Denmark, and some other European cities, public agencies are responsible for tactical planning, but delivery is competitively tendered. This approach has delivered cost savings, but is perceived to suffer from the disadvantage of a lack of "incentives to respond to market needs" (Van de Velde, 1999, p. 147). This has led to support for the concession system in which the public agency sets strategic objectives in the form of minimum standards and seeks bids from operators for both tactical and operational planning and delivery (e.g. Commission of the

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European Communities, 1996). The concession system, or ‘franchising’, was the basis for the privatization of British Rail in the 1990s.

Melbourne, Australia, offers a relatively rare example of the application of the concession system to a large, multimodal urban public transport undertaking. Melbourne has taken competition in public transport further than any other Australian city: while Adelaide and Perth have introduced competitive tendering for bus services, this has followed the model seen in places like London. By contrast, in 1999, Melbourne’s rail and tram services were fully privatized (government bus services had been privatized earlier in the 1990s). Rural rail passenger and freight services in the State of Victoria were also privatized in 1999, but this paper does not report on experience in these areas, except insofar as aggregated data on passenger services does not permit separation of figures for non-urban services.

The Melbourne privatization was based on the British Rail experience, from which the label ‘franchising’ was borrowed, but those implementing it claimed to have learned lessons from the problems with rail and bus privatization in the UK (Greig, 2000, p. 241). Many of the officials and consultants involved in the Melbourne privatization had worked on the UK rail privatization (Cole, 2003). The Melbourne franchises promised the best of all possible worlds: improved services, increased patronage, reduced government subsidies and no real increases in fares. As a result, the city was hailed as a model by advocates of privatization. The franchises were praised by local commentators (except the present writer) and delegations from other cities visited regularly seeking to learn from Melbourne’s experience. Even the Toronto Transit Commission, frequently cited as one of the English-speaking world’s most effective transit operators (e.g. Mees, 2000), was admonished by the Provincial Premier to follow Melbourne (*Toronto Star*, 23 October 2002).

Ironically, at the same time, politicians in Melbourne were grappling with the unravelling of the policy that was attracting this praise. In February 2002, the Victorian government announced that it would pay the three private rail and tram franchisees $105 million in addition to the subsidies provided in their franchise agreements, following a threat by the operators to pull out of providing public transport in the State. Further contract revisions leading to additional subsidy increases were foreshadowed. In December, the UK firm National Express withdrew financial support for its subsidiaries that operated three of the Victorian franchises. The Victorian government appointed receivers to manage the businesses and announced that it would be seeking to re-franchise Melbourne’s train and tram systems.

In its 2003/04 budget, delivered in May 2003, the government made an allowance of approximately $1 billion[1] over the next 5 years to cover subsidy increases not foreseen at the time of privatization. Finally, in February 2004, the state government announced that it had agreed to pay the two remaining operators $2.3 billion, or around $1 billion more than forecast, to take over the train and tram systems for 5 years, following which they would be re-franchised.

What has gone wrong with the privatization of public transport in Melbourne? Do the difficulties reveal failure, or are they simply ‘teething problems’ in a process that will eventually produce a sound outcome? To date, most local commentary has been from pro-privatization sources, which have argued the latter case. Greig (2002, pp. 250–251), one of the key officials who worked on the Victorian privatization, predicted that “gains to the state … will still be substantial compared with the alternative of continued public sector operation". Moran (2002) of the Institute of Public Affairs, a 'dry' economic think-tank, expanded on Greig's point, arguing that despite the setbacks, privatization has still produced "three years solid performance" characterized by large savings in operating subsidies, and improvements in punctuality and reliability.

The purpose of the present paper is to evaluate the results to date of the Melbourne privatization, with a view to establishing whether it represents an improvement over continued government operation. Although the process is only 4 years into contracts originally intended to last 12–15 years, it is anticipated that it should be possible to draw broad conclusions about the direction of change and the likelihood of reaching the outcomes predicted at the time of privatization.

Background to Privatization in Melbourne

Metropolitan Melbourne's 3.4 million residents are served by unusually large train and tram systems. The rail system incorporates 15 electrified lines radiating from an underground CBD loop, and in 1999, it carried 126 million passengers in 907 EMU carriages. The tram system features some two dozen mainly radial routes, served by 476 vehicles and carrying 123 million passengers annually. Rail and tram services in Victoria were operated by government agencies for many decades, while most bus services were provided by private firms. In the early 1970s, falling patronage saw government subsidies provided to the public and private operators to keep trains, trams and buses running. Mees (2000) argued that the legacy of this history was a system of perverse incentives that resulted in the different operators competing with one another rather than with the private automobile. Over the 1980s, the government agencies were amalgamated to form the Public Transport Corporation (PTC), which in Melbourne traded as 'The Met', but genuinely integrated service planning and provision did not eventuate, as different divisions of the organization retained the organizational cultures inherited from previous arrangements.

In 1993, the newly elected Liberal government[2] commenced the Public Transport Reform Program, designed to improve the efficiency of the PTC. Over the next 5 years, the PTC's workforce and cash operating subsidy were more than halved, as a result of rationalization of workshops and crewing, along with extensive outsourcing (Auditor-General of Victoria, 1998).

The Reform Program also saw the privatization of Melbourne's publicly operated bus services. The Victorian government and other commentators claimed that in addition to cost savings, bus privatization had led to improved services that in turn produced increased patronage. Mees (1999) concluded that the claims were false, with patronage, in particular, having declined. When the author presented these conclusions at the 1999 Australasian Transport Research Forum, a consultant in the audience stated that her firm had also prepared a report for the Victorian government that concluded that bus patronage declined post-privatization, but had been instructed to delete the relevant section from the final report!

Rail and tram services remained in government hands, and the Liberal government went to the state election of 1996 promising to corporatize, but not to privatize, them. However, in March 1997, PTC employees took industrial action that led to a cessation of services to the Australian Formula 1 Grand Prix, and the Victorian government announced that, in response, the PTC would be privatized. The necessary legislation was enacted late in 1997, and a transport reform unit was established in the State Treasury department to oversee the franchising process.

Outright sale of the businesses was rejected because of the requirement for ongoing subsidies. Tendering of services within a framework of central planning was also rejected because it was "not seen as a good basis for investment and innovation" (Greig, 2000, p. 240). The preferred alternative was franchising, with contracts overseen by a semi-independent Office of the Director of Public Transport. The Director was the party that entered the contracts with the operators on behalf of the State, and was also the regulator responsible for overseeing compliance by the operators with the franchise conditions. The model chosen provides neatly fits the definition of concessioning given by Van de Velde (1999, p. 155).

On 1 July 1998, the PTC's passenger operation was split into five separate corporations: V/Line for country rail and feeder bus services, Bayside and Hillside trains (each covering roughly half the Melbourne rail network), and Swanston and Yarra trams. Expressions of interest were invited in October 1998, five successful bidders were selected in June 1999 and the five operating franchises took effect on 29 August 1999. The following month, the Liberal party was unexpectedly defeated at the state election, and the Australian Labor Party took over government in Victoria.

Three of the franchises (V/Line, Bayside Trains and Swanston Trams) were awarded to the UK transport operator National Express. The Yarra Trams franchise went to a consortium led by French bus and tram operator Transdev, while another French firm, Vivendi/Connex, won the Hillside Trains franchise.

Initially, little information was made available to the public about the precise terms of the franchises, which were declared 'commercial-in-confidence'. However, in 1999, the new Labor state government established an Audit Review of Government Contracts to consider the Liberal-era privatizations, including that of public transport. The review recommended that most parts of the franchise agreements be made available to the public, and in addition its report (Russell *et al.*, 2000) contains information about the details of the process. Much of the information in the Audit Review report comes in turn from an overview report prepared by the Department of Treasury & Finance in April 2000.[3]

The Audit Review report (p. 146) listed the objectives the Victorian government had offered for the franchising of train and tram services as follows:

- To secure a progressive improvement in the quality of services.
- To secure a substantial and sustained increase in the number of passengers.
- To minimize the long-term costs of public transport to the taxpayer.
- To transfer risk to the private sector.
- To ensure that the highest standards of safety were maintained.

The review's conclusion was that the contracts set in place were likely to achieve the desired objectives. Costs to taxpayers would decline over the life of the contracts, producing a saving compared with public operation estimated at $1.8 billion over the 12–15-year life of the franchises. Total annual subsidies paid to the operators would progressively decline over the period. These savings would be achieved mainly as a result of spectacular increases in patronage, ranging from 40% for Swanston Trams to 84% for Bayside Trains. The patronage increases would be guaranteed by an innovative subsidy regime, which provided for phasing out of fixed subsidies over the life of the contracts in favour of 'incentive-based' payments, granted in return for patronage increases. And all this would be accompanied by a substantial programme of investment in new and upgraded rolling stock and infrastructure.

A single note of caution was sounded:

> [I]t needs to be kept in mind that financial savings, new investment and patronage growth on which train and tram franchise contracts are based are yet to be delivered. (Russell *et al.*, 2000, p. 150)

The remainder of this paper considers the extent to which the outcomes have in fact been delivered, and the reasons why.

Increased Patronage

Public transport patronage in Melbourne declined continuously from the end of the Second World War to the early 1980s. Following the introduction of multi-modal ticketing in 1981, the trend was halted and reversed (Mees, 2000, pp. 274–278). Industrial problems associated with an industrial dispute in 1989–90 over the removal of tram conductors, followed by substantial fares rises and, then, in the early years of the Liberal government of the 1990s, service cuts and further fare rises, saw patronage dip. By 1994, patronage had begun to recover, and for the remainder of the decade increased at around 2% annually, a figure roughly in line with Melbourne's population growth (Auditor-General of Victoria, 1998, p. 109). Interestingly, the Treasury report cited an increase of only 1% per annum, a figure arrived at by averaging the whole period between 1991 and 1999, including the earlier years of patronage decline (Department of Treasury & Finance, 2000, p. 133). The Treasury's estimates resulted in the appearance of a poorer patronage performance under PTC management than those cited by the Auditor-General.

Privatization aimed to improve on this rate of increase, with each franchise agreement based on the assumption of much larger rises. Each agreement contains details of projected increases in real fare revenue, which can be used to estimate the rates at which patronage was expected to increase from year to year over the life of the contract. For example, the figures for Bayside Trains (Table 1) indicate that real fare revenue was expected to increase from $101 million in the financial year ending on 30 June 2000 (the first year of operation) to $214 million in 2014. The 112% increase in fare revenue is greater than the 84% increase in patronage because it is expected that, over time, trips will lengthen due to metropolitan growth, increasing revenue per trip (under Melbourne's zone-based fare system, the cost of travel is roughly proportional to distance), and because most new passengers are expected to be 'choice' customers paying full fares rather than 'captives' on concession tickets. But the bulk of this growth was projected to occur within the first 5 years of private operation.

Patronage was expected to jump dramatically immediately after privatization, with the rate of increase settling back to roughly the same levels as had occurred under public ownership by the sixth or seventh year. A similar pattern can be found in the other three metropolitan franchise agreements (Tables A1–4). The assumptions underlying these projections was stated by Greig (2000, p. 245), a key participant, as follows:

Table 1. Projected revenue growth, Bayside Trains

Financial year	Revenue ($ millions)	Increase over previous year (%)
2000	101	n.a.
2001	116	15.5
2002	132	13.6
2003	146	10.4
2004	158	9.5
2005	166	5.6
2006	173	3.7
2007	177	2.8
2008	183	3.0
2009	188	2.7
2010	193	2.7
2011	198	2.7
2012	203	2.6
2013	208	2.6
2014	214	2.5

Source: Bayside Trains Franchise Agreement, Schedule 14, pp. 295–296.

> The optimism on patronage was based on judgments about marketing (the PTC did very little), better integration with feeder buses (all the new franchisees are experienced bus operators), better rolling stock, more express services, better real time passenger information, and safer and more attractive stations. The case for optimism was bolstered by the experience of large patronage increases following privatisation elsewhere (for example, UK, Argentina).

And, happily, the increased patronage would come mainly in off-peak and shoulder periods where there is spare capacity, thus avoiding the need for commensurate increases in service levels and costs (Greig, 2002, p. 245).

One consequence of this projected revenue pattern is that it should be possible to gauge progress even based on figures for the first 4 years. Data from Victorian budget papers (Government of Victoria, 2004) shows that Melbourne train patronage increased by 7% from financial year 1999 to 2004, while tram patronage rose by 6%. This is a slightly lower rate than was being achieved before 1999, and dramatically lower than the 48% increase in train revenue and 44% in tram revenue projected for this period (Tables 1 and A1–3). Given the high rate of economic and employment growth in Melbourne in recent years, it appears that privatization has had no effect on patronage.[4]

Although press reports blamed the financial problems of the private operators on Melbourne's failed ticketing system (itself the result of another Liberal-era privatization), the GST, power price rises and an inability to cut labour costs (e.g. Baker, 2002), the figures in the franchise agreement make it clear that these are not the principal problems. Rather, the difficulty stems from the failure to achieve the ambitious patronage targets. On current trends, the Melbourne operators' total fare revenue will be less than $300 million (1999 dollars) in 2004, at least $100 million short of projections (cf. Table A2), and this revenue gap will widen even if patronage increases in following years match the franchise agreement projections.

In addition to the direct revenue loss, the failure to meet patronage targets means the operators have not been eligible to claim their patronage growth incentive payments.

The failure to meet patronage targets was explicitly recognized in the interim financial rescue package of February 2002, in two ways. First, the Victorian government provided the operators with "a one-off payment of $27 million tied to future agreement with the operators on business recovery proposals" (Batchelor, 2002). It was subsequently reported that this funding would be used to develop a marketing strategy designed to increase patronage, including the reinstatement of common branding and possible revival of 'The Met', the brand name used by the former PTC.

Second, and more significantly, the government also agreed to a revision of the patronage incentive payment scheme, which was said to be "unworkable and needs to be replaced with a system that recognises that the operators are achieving patronage growth" (Batchelor, 2002). In other words, the scheme in the franchise agreements, which required the private operators to improve on the rate of patronage growth achieved by the PTC to be eligible for bonus payments, would be replaced by one that rewarded them for not performing any better than the PTC did.

However, not even this could save the private operators' finances. On 16 December, the National Express parent group in the UK announced that it was withdrawing financial support for its subsidiaries Bayside Trains, Swanston Trams and V/Line. The government appointed receivers to run these businesses and announced further interim funding to keep the two remaining private firms afloat. The government also announced at this time that the Melbourne operations would be re-franchised on the model of one train operator and one tram operator. In February 2004, the state government announced that Yarra Trams and Connex had agreed to run the tram and train systems, respectively, for a further 5 years, in return for subsidy payments of $2.3 billion. To date, little other information has been forthcoming about the precise terms of the new agreements.

Before turning to the long-term financial consequences of this situation for the Victorian government and community, it is necessary to consider why the operators failed to improve patronage performance.

Improved Services

Privatization was heralded as leading to improved services, but the first change passengers noticed was the rapid loss of the modest degree of system integration that had existed under the PTC. Each operator redesigned vehicles, timetables and stops in its own livery, and began to treat the other operators as rivals—a pattern that would be familiar to observers of the post-privatization scene in the UK. For example, for many months, timetables for train services operated by Hillside trains could not be obtained from Flagstaff, Melbourne Central or Parliament stations on the CBD loop, which were operated by Bayside Trains—even though the Hillside services called at those stations. Even the operators eventually conceded that this did not constitute an improvement in services by announcing, in April 2002, their intention to reinstate common 'branding' based around the PTC's old brand name: 'The Met'. However, when the re-branding was launched in August 2003, it emerged that a 'Metlink' logo would be added to those of the individual operators, not used as a replacement, further confusing the picture for patrons.

The principal aspects of service quality that have been reported on since privatization are cancellations and on-time running. The media have widely reported that these have improved since privatization, a conclusion supported by Stanley and Hensher (2003, pp. 10–11). These reports are based on the figures released in *Track Record*, a newsletter published by the Director of Public Transport that compares current reliability figures with those for 1999. The comparison does not, however, represent the true pre-privatization situation, because reliability had deteriorated in the lead-up to privatization due to operational problems associated with the splitting of the rail and tram networks into five separate entities. The problems were particularly serious in the case of the rail system. Therefore, an accurate comparison would be with the situation, and the trend, before the commencement of privatization.

Table 2 illustrates the point. It compares 2001/2 figures with those for 1998/9, as the director's published figures do, but adds those for 1996/7, i.e. before the pre-privatization reorganization began. Comparisons are complicated by the fact that some of the definitions used have altered (Table 2, note), but it is apparent that the situation deteriorated in the lead-up to privatization. This can be seen most clearly in the figures for cancellations, the definition of which has not changed. Although punctuality and reliability have improved since 1999, they are no better than was the case in 1997. The Auditor-General noted in 1998 that the Public Transport Reform Program had produced a considerable improvement in the PTC's punctuality and reliability, and that the situation was expected to continue to improve (Auditor-General of Victoria, 1998, pt 5). Given that the situation was improving under the PTC, it appears that privatization has produced no improvement, and possibly a deterioration.

Some improvement in service levels was also promised as part of the franchise agreements, notably in the case of Yarra Trams, which undertook to upgrade daytime weekday service frequencies on all its routes to 10 minutes. Seven of Yarra's ten routes already complied with this under PTC management; the remaining three ran every 12 minutes and have since been upgraded to every 10 (7.5 in one case) minutes. In addition, the franchise agreements provided for two modest network extensions: a 2-km extension of tram route 109 to Box Hill and a 7-km extension of the St Albans rail line to Sydenham. These were all genuine improvements, but were comparable with similar service and network expansion that had already taken place, and which would presumably have continued, under PTC control.

Table 2. Cancellations and late running

Year	2001/2	1998/9	1996/7
Trains cancelled (%)	0.5	1.0	0.5
Trams cancelled (%)	0.4	1.1	0.2
Trains late (%)	3.3	6.1	5.2
Trams late (%)	29.2	31.5	14.0

Note: The definition of late train was relaxed from 5 to 6 minutes between 1997 and 1999, making it more generous to operators; the definition of a late tram was changed from the time of departure at the origin to the time of arrival at the destination, making it less generous to operators.
Sources: Auditor-General (1998, p. 45); *Track Record* (various edns), cited in Moran (2002).

What was widely anticipated, although not explicitly provided for in the franchise agreements, was that the requirement to increase fare revenue would lead the operators to introduce innovative service, fare and marketing strategies (cf. Greig, 2002). To date, there has been little evidence of successful innovation. A number of changes were introduced (e.g. 'shopper express' services on Hillside trains; single-mode yearly tickets by both rail operators), and withdrawn after a short time.

The major lasting new product has been Yarra Trams' 'park-and-ride' scheme, whereby motorists parking at three car parks on the edge of the CBD receive free tram travel as part of the cost of their parking. Some patrons of this service are likely to have formerly driven their cars into the city centre, but given that the park-and-ride stations are on the edge of the CBD, the overall reduction in pollution and traffic congestion is likely to be minimal. Another effect of this programme is likely to be a transfer of passengers who currently use trains to travel to the city, providing a classic instance of 'wasteful competition' that is likely to worsen environmental outcomes. Presumably for this reason, National Express, which operated both Bayside Trains and Swanston Trams, did not introduce a similar scheme.

The private operators were required under their franchise agreements to refurbish their rolling stock, but this was a regular occurrence under public ownership. Perhaps more significantly, they also agreed to lease around $1 billion-worth of new rolling stock (the vehicles, and the remaining lease payments, were to revert to the State on expiry of the franchises). It is quite likely that the arrival of the new rolling stock has been accelerated as a result of privatization (because of the reluctance of governments to invest in this area), but Mees (2000) has argued elsewhere that there is very little evidence to support the proposition that new vehicles per se constitute a significant improvement from the passengers' point of view. The Melbourne private operators appeared to agree, because their revenue projections assumed that the most rapid increase in patronage would occur in the early years of the franchises, i.e. before the arrival of the new rolling stock (Table A1).

The failure to better the PTC's performance in service provision and innovation is the principal reason why the private operators have failed to meet their patronage and revenue targets. It is clear from the revenue projections that an immediate, dramatic improvement in standards was expected to flow from privatization; it is equally clear that this has not occurred and it shows no sign of happening, despite attempts at 'spin' by the operators, privatization advocates and the supposedly independent regulator.

Minimizing the Risk to the Taxpayer

The financial problems of the operators were indeed serious, but it does not follow that they should flow through to taxpayers. Indeed, the Audit Review of Government Contracts concluded that:

> For trains and trams, substantially all the commercial risks associated with the provision of passenger rail/tram services were transferred to the franchisees. Except in limited circumstances, franchisees have assumed revenue, operating, ownership and legal risks. (Russell *et al.*, 2000, p. 154)

This assessment appears to have been correct as a matter of law, but ignored the political realities of the situation, and the opportunity it presented for 'rent seeking'. To date, the two surviving operators have shown a remarkable ability to transfer risk back to the public purse. The State's re-assumption of revenue risk is discussed below, but the operators have also been successful at transferring risk on the cost side, with the State paying for cost overruns on both the Box Hill tram extension ($5 million of a total cost of $14 million) and the Sydenham rail extension ($17 million out of $42 million). The franchise agreements provided that the operators were to meet the full cost of each of these projects.

A similar situation applies in respect of new State initiatives. On this point, the Audit Review was again sanguine, observing that "governments retain the flexibility to establish new priorities and programs without unreasonably disadvantaging incumbent operators" (pp. 159–160). But, as with other risks, the actual outcome has been quite different. The Labor government came to office in 1999 promising a number of public transport initiatives, including line extensions. Most have been placed on hold owing to higher-than-anticipated costs.

The cost blow-out appears to be a direct result of rent seeking by the private operators. For example, the electrification in 1995 of the 13-km line from Dandenong to Pakenham, with two new stations, cost $27 million under the PTC (Auditor-General of Victoria, 1998, p. 99). But electrification for the 9 km from Broadmeadows to Craigieburn, also with two stations, is projected to cost $98 million (Government of Victoria, 2002), plus an annual operating subsidy of $7 million (the State budget papers do not make it clear how many years this subsidy will last).

Minimizing Costs and Revenue Risk

In his 1998 report on the Public Transport Reform Program, the Auditor-General of Victoria discussed the impending privatization. He concluded that '[a]fter 6 years of cost-cutting and rationalisation of operations, there appears to be limited scope for further large savings' (Auditor-General of Victoria, 1998, p. 123, para. 9.3). It appears he was correct.

The ability of the operators to shift risk back to the government has eroded the cost savings promised at the time of privatization. But these savings appear to have been exaggerated in any event. The total saving of $1.76 billion over the life of the franchises was estimated by the Treasury Department's privatization unit (Department of Treasury & Finance, 2000, pp. 130–132). But the calculations, of which no details were provided publicly and few were provided even in the Treasury report, did not compare subsidies paid to the private operators with those paid to the PTC. Instead, the cost of the franchises was compared with something called the 'Public Sector Benchmark' (PSB), which was an estimate of the costs of continued public operation. Closer examination of this process reveals a series of dubious assumptions, which collectively have the effect of overstating the savings from privatization.

The components of the PSB are set out in Table 3; the corresponding figure for franchised operation is in Table 4.

First, note that exactly half the PSB is made up of an 'Infrastructure capital charge' (Table 3). This figure, which supposedly represents an allowance for past government capital grants to the PTC, was introduced into the PTC's accounts for the first time in financial year 1998/99 (i.e. once privatization was underway). It

Table 3. Public sector benchmark ($ million per annum)

Operating deficit:	169
Depreciation:	190
Capital charge on rolling stock and infrastructure:	359
Total:	718

Source: Department of Treasury & Finance (2000, p. 130, table 5.12).

was calculated based on 'around *15%* of the written-down *replacement cost* of the [PTC's] non-current physical assets' (Auditor-General of Victoria, 2000, p. 113, emphases added). The first problem with this item is that the amount allowed for replacement costs is largely arbitrary, as most of the assets in question (e.g. stations and bridges) were provided many decades ago and, if replaced, might be replaced with very different types or configurations of assets. The second problem is that as the Auditor-General of Victoria (2000, p. 113, emphases added) noted, "capital asset charges are generally imposed on the *written-down value* of non-current physical assets, with the charges generally set at *8%*". In other words, the charge applied to the PTC was calculated on a different basis from that applied to other departments, resulting in a figure more than twice as high as would have been the case had it been calculated in accordance with the normal practice. No explanation for the discrepancy has been offered, and the Auditor-General drew no conclusions as to Treasury's motivation.

Under privatization, the capital charge falls by $112 million per annum (Table 4). No explanation has been provided about why a shift to private ownership should have this effect, given that the capital charge is supposed to represent past government grants. The reason appears to be that the PTC's rolling stock was 'sold' to the private operators for a nominal consideration, and the capital charge for rolling stock has been replaced by an annual allowance of $51 million for amortization of the $663 million 'loss' from this 'sale' (Auditor-General of Victoria, 2000, 115). But, because the amortization allowance is based on the current value of the rolling stock rather than replacement value and employs an interest rate of 9.5% as opposed to the 15% used to calculate the PSB (Department of Treasury & Finance, 2000, pp. 130–131), the result is a net annual 'saving' of $61 million compared with the PSB. Given the above discussion, it should be clear that, at best, this amount reflects the results of a debatable book-keeping exercise rather than a genuine reduction in public expenditure. Excluding it reduces savings over the life of the franchises by around $800 million.

Table 4. Cost of franchises vs. PSB $m per annum

PSB:	718
Cost of payments to franchisees:	226
Amortization of cost of existing rolling stock:	51
Costs of privatization (amortised) and monitoring:	31
Infrastructure capital charge:	247
Total cost of franchises:	567
Annual saving:	161

Source: Department of Treasury & Finance (2000, p. 131, table 5.13).

The second problem is that the estimates of the PSB and private sector costs excluded amounts paid by the government for reimbursement of concession fares (Department of Treasury & Finance, 2000, p. 131), estimated to be some $500 million over the life of the franchises (Auditor-General of Victoria, 2000, p. 122). Since the private operators anticipated carrying higher patronage than the PTC, they would have received higher concession recoupment payments; omitting this genuine increase in public outlays from the analysis overstates the savings from privatization. However, since the higher patronage has not eventuated, these higher payments are now unlikely to be made.

It appears, therefore, that the saving in public subsidies under the franchises was closer to $1.1 billion than the claimed $1.76 billion. Unfortunately, it is not possible to be more conclusive than this, as little useful information about subsidy levels has been publicly released since. To the extent that there are genuine savings, these were almost entirely a result of projections of substantial revenue increases following privatization. Since the revenue increases have not occurred, neither have the savings. The State's 2003 Budget Statement confirmed this conclusion, stating: "An allowance has been made of around $1 billion over five years in anticipation of higher public transport costs" (Government of Victoria, 2003, p. 137). This prediction was borne out when it was announced in February 2004 that Yarra Trams and Connex would be paid an extra $1 billion over 5 years to keep the system going (Heasley, 2004). To this amount must be added the costs of the 2002–03 rescue package and associated measures, which were assessed by the Auditor-General of Victoria (2003, p. 75) to amount to $331 million. Although National Express forfeited a performance bond of $135 million, the state was still out of pocket by $196 million.

The overall result appears to be that the additional financial costs to the state have more than outweighed the savings from privatization. The state's transport minister conceded to journalists that the government's own evaluation had concluded that private operation was no cheaper than public management, but "what tipped the balance in favour of pursuing privatisation was the demonstrable improvements Connex and Yarra Trams had introduced, and the absence of clamour for public sector retention" (Heasley, 2004).

Why Did Privatization Fail?

Why did privatization fail? The simple answer is that the principal assumption underlying privatization—that superior private management would rapidly bring about a substantial rise in patronage and revenue—has been proven wrong, even after only 4 years. The private franchisees have not significantly improved service quality, and the mooted improved marketing appears to be confined largely to the circulation of exaggerated claims about the operators' performance. While these claims have been eagerly adopted by the regulator, politicians, bureaucrats and the media, they have apparently failed to convince the travelling public.

The Victorian process saw the state government set the objectives at the strategic level, but rely on the franchisees for both tactical and operational planning. The assumption was that private operators could be forced to carry out the tactical planning necessary to expand the market by providing them with appropriate financial incentives. The public sector would use financial rewards to operators as a substitute for central planning. This assumption has also proven false, at least in the Melbourne case.

The franchises sought to transfer revenue risk to the private operators and, as a matter of strict legal formality, this was achieved. What those who designed the system failed to appreciate was the ability of the operators to exert political pressure to vary the terms of their contracts to throw revenue risk back onto the State. The likelihood this happening was high because the privatization of public transport was politically controversial. The key players—the Liberal government, key bureaucrats and even the regulator—saw themselves as defenders of the privatized system, which could not be seen to 'fail'.

A similar process had already been seen with the privatization in 1994 of government bus services, which led to misleading claims about improved services and patronage, and, in 1997, a secret renegotiation of the operator's franchise involving an increase in the agreed subsidy level (Mees, 1999). This environment, together with the secrecy arising from 'commercial-in-confidence' contracts, the opaque accounting methods employed (see the discussion above about the capital asset charge) and a largely uncritical media supportive of privatization created a 'moral hazard' situation in which the agents involved in the privatization in 1999 could not be held to account to their principal (the public). In other words, the regulators were 'captured' by the regulated from the outset of the process, providing an attractive opportunity for 'rent-seeking'.

The extent of this regulatory capture, and the fact that it occurred almost immediately, is demonstrated by the efforts employed by the Department of Treasury & Finance and the Director of Public Transport to put the best possible 'spin' on the outcomes of franchising (see the discussion above of patronage increase rates under the PTC, reliability and the estimation of cost savings).

The next phase of this exercise was the negotiations between the government and the two remaining private operators over re-franchising of the system, i.e. for Yarra/Transdev to take over the whole tram system, and for Connex/Vivendi to take over the urban rail system. Greig (2002, p. 250) predicted that the additional payments required would be "modest compared with the originally estimated gains", but they were not. Owing to the lack of interest from other private operators in bidding (a result of experiences in Melbourne and other places such as the UK), and the government having ruled out in advance a public take-over or even a Perth/Adelaide-style move to sub-contracting, the two remaining private operators were in a position to dive a hard bargain in the negotiations, which were also conducted in secret on a commercial-in-confidence basis.

The result is a classic 'moral hazard' problem, in which all the players have an incentive to collude against the public interest. Unrestrained by the threat of competition from other firms or a public take-over, rational private operators would seek to maximize subsidies and fare increases, and minimize obligations. Anxious to avoid public acknowledgement of failure, the public servants overseeing the process—in the main, the same people responsible for the privatization in 1999—had a strong incentive to accept the operators' terms. An early indication of the direction of the negotiations came in November 2003, when a local newspaper leaked the news that the government had agreed to drop the prohibition on above-inflation fare rises, leading to a 10% increase for 2004 above the extra $1 billion in subsidies.

Perhaps the only surprise is that the incoming Labor government seems prepared to cooperate with the various vested interests to cover up the failure of a programme initiated by its predecessors and political rivals. Explaining this is beyond the scope of this paper, but it is worth recalling that Victorian Labor was surprised to win the 1999 election and unprepared for government. The government's rapid capture by the 'privatization lobby' was probably assisted by the glowing report provided by the Audit Review committee (which in turn was based largely on the assessment provided by the Department of Treasury & Finance), as well as the passive attitude of the regulator.

It is also noteworthy that from the first day of the Labor government, the two private operators that currently remain in Melbourne devoted considerable energy to lobbying, in a classic illustration of rent-seeking behaviour. This involved the organization of a steady stream of 'photo opportunities' for the incoming Minister for Transport. Yarra Trams appointed a new chairman shortly after the election in 1999: the appointee was a former Labor cabinet minister who at the time was acting as a semi-official mentor to the incoming government. While the private operators have not shown much skill at marketing their services to the travelling public, they succeeded handsomely at marketing themselves to the new government!

Conclusions

At this point, it is reasonable to ask whether the Melbourne outcome was avoidable. Stanley and Hensher (2003, p. 15, n. 13), as an example of regulatory capture, cite "winning a tender on an artificially low bid, with a view to renegotiating that bid upwards at a later stage by threatening service disruption, presuming that government will be unable to resist political pressure on service continuity", but prudently refrain from expressing judgement about whether Melbourne provides an example of such behaviour. Kain (2002, pp. 57–58), discussing the case of the UK Channel Tunnel Rail Link, comments:

> Once the Agreement was signed, if the private (or public) partner sought to renege on the original terms, government incurred very heavy sunk transaction costs. … [This] conspired to generate tactical approaches by bidders that worked away from commercial—'principal' behaviour [and] encourage unrealistic (but Bid-winning) projections. Further, having won the bid, the government's failure to transfer risk did not encourage the private partner to behave as an efficiency-maximising 'principal'. … The private partner could seek renegotiation after becoming entrenched.

Adopting Kain's analysis, overconfidence by the officials responsible for the Melbourne privatization about the extent to which revenue risk had really been transferred to the franchisees established an environment that encouraged franchisees to make unrealistic bids to secure a 'foothold', then subsequently to seek to renegotiate more favourable terms.

In theory, this problem could have been avoided had the process been designed more carefully, but it is worth recalling that the designers of the Melbourne franchising system expressly stated that they had learned from the problems experienced with privatization in the UK, and had carefully structured the franchise arrangements to avoid these problems. While this task might be possible in theory, in practice it may be beyond the capacity of governments, at least in the case of large, multimodal systems. Note that there is likely to be an imbalance in negotiating expertise between an experienced international firm and the municipal governments charged with providing urban public transport.[5]

Indeed, the task of a regulator under such a system appears to require greater skill than is needed actually to operate a public transport system, either directly or using sub-contracting. It is noteworthy that the Office of the Director of Public Transport in Victoria employs twice as many staff as the Zurcher Verkehrsverbund, the operator of the (sub-contracted) Zurich, Switzerland, regional transit system, which is internationally renowned for its effectiveness (Mees, 2000, ch. 5). Not only are the skills required extremely high, but also the lack of transparency arising from complex contracts, secrecy and political 'spin' means that such agents might actually be less accountable to the principal/public than is the case under a public system in a functioning democracy.

Although it appears privatization in Melbourne has performed less effectively than would continued public operation, the present author does not wish to be taken as suggesting that this was the only alternative. Competitive tendering with public planning remains an option, while Stanley and Hensher (2003) advocate greater attention to tactical planning through performance-based contracts. It may even be possible to design a workable concessioning system for the re-franchising proposed for Melbourne in 5 years' time, but given the experience to date, one would not be optimistic.

Notes

1. All figures are in Australian dollars. At the time of writing (June 2004), Au$1.00 bought US$0.70, £0.38 or €0.57.
2. Despite its name, the Liberal Party in Australia is the equivalent of the Conservatives in the UK or Canada.
3. The author is grateful to Andrew Cole, who obtained this document under Freedom of Information laws for his thesis (Cole, 2003), for allowing him to access to it.
4. Stanley and Hensher (2003, p. 12) are more optimistic, but their conclusion is based on the Treasury assumption that patronage was increasing at 1% rather than 2% per annum before privatization (see the above discussion).
5. Approximately three-quarters of the population of Victoria live in Melbourne, so the State government is effectively a 'municipal' operation.

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Appendix

Table A1. Projected revenue growth, Hillside Trains

Financial year	Revenue ($ millions)	Increase over previous year (%)
2000	84	n.a.
2001	97	15.8
2002	104	7.5
2003	110	5.7
2004	116	5.6
2005	122	4.6
2006	125	2.5
2007	128	2.5
2008	131	2.4
2009	134	2.1
2010	137	2.1
2011	139	2.1
2012	142	1.6
2013	144	1.6
2014	146	1.4

Source: Hillside Trains Franchise Agreement, Schedule 14, p. 247.

Table A2. Projected revenue growth, Swanston Trams

Financial year	Revenue ($ millions)	Increase over previous year (%)
2000	48	n.a.
2001	52	9.4
2002	58	11.1
2003	64	9.3
2004	66	3.4
2005	68	2.9
2006	70	2.6
2007	71	2.4
2008	73	2.1
2009	74	1.7
2010	75	1.6
2011	76	1.6
2012	77	1.3

Source: Swanston Trams Franchise Agreement, Schedule 14, p. 365.

Table A3. Projected revenue growth, Yarra Trams

Financial year	Revenue ($ millions)	Increase over previous year (%)
2000	40	n.a.
2001	48	17.9
2002	54	13.1
2003	58	7.1
2004	61	5.5
2005	64	5.0
2006	66	2.8
2007	67	2.3
2008	69	2.4
2009	71	2.4
2010	72	2.4
2011	74	2.4
2012	76	3.0

Source: Yarra Trams Franchise Agreement, Schedule 14, p. 295.

Table A4. Projected revenue growth, all Melbourne operators

Financial year	Revenue ($ millions)	Increase over previous year (%)
2000	273	n.a.
2001	313	14.9
2002	349	11.2
2003	377	8.3
2004	401	6.2
2005	420	4.8
2006	433	3.0
2007	444	2.6
2008	455	2.6
2009	466	2.3
2010	477	2.3
2011	488	2.3
2012	498	2.2

Source: Tables 1–4.