

CHAPTER 1

INTRODUCTION AND OUTLINE OF THE STUDY

1.1 Background to the study

1.1.1 Overview of the evolution of the rail industry in South Africa

In the evolution of state ownership and the control of railways, the seed of state ownership was already planted when the first railway construction project was conceived in South Africa. The first main company was established as a private concern and was operated on the authority of the Cape government, which provided financial guarantees (South African Railways (SAR), 1947: 31). Apart from some minor lines that were operated by other companies, this company operated the main lines and was known as the Cape Town Railway and Dock Company until it closed on the 1 January 1873 (Standard Encyclopaedia of South Africa, 1973. s.v. "Railways").

The Natal Railway Company was established in Durban and operated as a private railway until it closed on 1 July 1876. This was as a result of the Natal government's decision to purchase the small railway line that ran between Point, Durban and Umgeni (SAR, 1947: 31).

In the hinterland, specifically the Transvaal, the Netherlands South Africa Company was dominant. The rail system of this company was divided into various areas, including what was known as the Rand Tram area. It originally operated between Boksburg and Johannesburg and was subsequently extended to Springs. Government control over railways in the Transvaal territory was maintained to a limited extent in the form of the Railway Commission, which was required to report to the Volksraad. Apart from the Netherlands Railway Company, there were some other independent railway concerns that originated in Belgium. The Pretoria-Pietersburg Company was one of these and it allowed subscription to its shares by the government. This share subscription offered a

point of entry for the government of the Transvaal into the field of railway construction and ownership. The Boer War, however, contributed to the slow death of the Netherlands Railway Company in the Transvaal and it finally succumbed at the end of the second South African war (SAR, 1947: 33). In South Africa, therefore, state ownership of railways was inevitable from the outset (SESA, 1973, s.v. "Railways").

When the Union of South Africa was established in 1910, the various private railway companies were already nationalised. As a result, there were different government-owned railways companies. The Central Government Railways administered railways in the Transvaal and the Orange Free State. The Cape Government Railways operated in the Cape and the Natal Government Railways in Natal. After the establishment of the Union of South Africa these government railways all had to be consolidated under one management. The South African Railways emerged from this consolidation. The final merger was, however, only achieved in 1916 (SAR., 1947: 22). The case for state ownership of railways in South Africa can be understood from the following statement:

In new countries like South Africa, railways are necessary to develop vast and thinly-peopled areas even before they would pay for the purpose of commerce. Private enterprise naturally hesitates to come forward, and in the few instances where it might be inclined to do so, it would be deterred by the prospects of competition, because the volume of traffic available is too small to be shared between lines. Private lines could only be constructed on a monopolist basis. But in a vast country, entirely devoid of waterways, it would be intolerable to have one private corporation controlling the entire system of communications. In these circumstances the government has itself undertaken the responsibility of building and administering the railways in South Africa (SAR, 1947: 35).

From this quotation it is clear that in South Africa the nationalisation of the railways was based on, inter alia, the role to be played by the rail industry in the

development of South Africa; a lack of enough traffic at that time to attract a significant number of private investors; and a lack of competition in and the monopolistic considerations of the industry at that time.

Potgieter and Shahia (1982: 25) mention that the South African Transport Services (SATS) were formally known as the Department of South African Railways and Harbours. The laws that were applicable to rail were subsequently repealed with the promulgation of the South African Transport Services Act 1981(Act 65 of 1981). This legislation provided for SATS to be managed according to business principles, but did not provide for the definition of the meaning and application of the business principles. In summary, the effects of the provision of the Act are that, firstly, as with an ordinary business, SATS had to be managed on purely business principles; secondly, it had to be financially independent of the Consolidated Income Fund; thirdly, it had to strive for a financial break-even situation as it lacked the profit motive, which is a distinguishing factor in an ordinary private business; fourthly, it had to consider economic interests and satisfy the total transport needs of South Africa; and fifthly the reference to the fulfilment of total transport needs of the Republic should not be interpreted as implying that the SATS had a monopoly in as far as transport activities were concerned (Potgieter & Shahia, 1982: 30). As a general observation the legislative mandate provided for, among other things, the unsatisfactory management environment in SATS with the resultant need for revision.

De Villiers reports (1986: 1) that the application of the then strategy by SATS entailed, among other things, the cross-subsidisation and subsidisation of services; a lack of the norm of return on capital and profitability which was inconsistent with the utilisation of investment and application of capital; the competitive advantage not being properly utilised; and the provision of rail services that did not have a competitive advantage and which even showed losses, which were in some cases extended and protected. This highlights some of the shortcomings of the SATS strategy. Furthermore, this report mentions that

“the present strategy which basically stems from the Act (referring to Act 65 of 1981) is no longer workable and acceptable” (De Villiers, 1986: 3). The strategy was no longer applicable because the developments of the past 50 years had changed the market demand for transport services radically. It should be mentioned here that “the change in the market demand” referred to by De Villiers stemmed from the competition from other modes like road-based transport. In an analysis of the application of the business principle by SATS, De Villiers (1986: 7) mentions that SATS could be seen as having pursued a dual directive of providing unprofitable socio-economic rail services which were based on political decisions and operating economic services. Guidelines were provided to assist in the transformation of SATS into business enterprises. In as far as commuter rail services were concerned, these services were to be provided by a separate undertaking that would need to be financially assisted by the state. A guideline was also provided for the division of commuter rail assets according to the physical (geographic) boundaries of their operation (De Villiers, 1986: 78–88). The legislation that ensued was the Legal Succession to the South African Transport Services Act (Act No. 9 of 1989, as amended). As an observation, the 1989 Act gave legal effect to some of the strategy proposals of the De Villiers report.

The Legal Succession Act established a public company (South Africa 1989, s 2(1)) known as Transnet Limited, as well as the South African Rail Commuter Corporation Limited (South Africa 1989, s 22(1)). In terms of this Act the rights of the state as member and shareholder of the company resides with the Minister of Public Enterprises (1989, s 2(3)), while those of the Corporation lie with the Minister of Transport (1989, s 25(3)).

1.1.2 Current transport policy environment

Consequent to the new political dispensation that came into effect in 1994, the National Department of Transport embarked on a policy review project early in

1995. This culminated in the tabling and approval of the White Paper on National Transport Policy in 1996.

In stating the role of government, the transport policy identified the weakness of the past government “as a regulator of bureaucratic detail, a provider of infrastructure, and a transport operator, but it (the past government) has been weak in policy formulation and in strategic planning” (Department of Transport, 1996: 7). According to transport policy, the present government intends to terminate this legacy by focusing on policy formulation and substantive regulation. In terms of the White Paper, the government also intends to reduce its direct involvement in the operation and provision of both infrastructure and services to allow for a more competitive environment. The reduction in the provision of transport infrastructure and services by the authorities can also be understood to apply to the rail industry in general.

Expanding on the question of regulation, the government would retain the regulatory role to ensure safety and quality; control of market access for transport operators; and the prohibition of excessive tariffs in the case of monopolies. In outlining the principles of regulation the policy states that these are a form of intervention by government and the intention would be to regulate only where it is essential. Various forms of regulations are laid down to regulate public transport and are firstly, the regulation of specific services provided under contract where the authorities impose a variety of sanctions if the services are not provided to the level required, this includes commuter rail services; secondly, the regulation of monopolies in which case the authorities control the tariffs and determine the services to be provided as well as the safety standards (this category includes rail concessions); thirdly, the regulation of competing operators; and fourthly, regulation by contract (Dept of Transport, 1996: 7–10).

Related to the principles of the regulations laid down by the transport policy as well as the forms of regulations given, are three broad forms of regulation. The first form is the economic regulation, which involves rates control; control of

entry of operators into the transport industry; the economic expansion or reduction of the transport enterprise; and regulation of the services provided by the operators. The economic type of regulation will be the focus of this study. There is, however, a second form of regulation, namely the safety regulation (Shahia & Ackerman, 1984: 16–21). The object of this regulation is to ensure the safety of users and to ensure a reliable service. Regulation here governs the condition of equipment; the qualification of operators; and operating procedures. The transport policy also includes this type of regulation. This will not however, be the focus area of this study. At the time of this study the Department of Transport had just come up with the National Railway Safety Act, which covers this type of regulation and has contributed tremendously towards the establishment of a Railway Safety Regulator. This latter type of regulation is part of the social policy (Shahia & Ackerman, 1984: 22).

Emanating from the government's role as the main regulator, the transport policy provides the framework for the provision of services. The framework states, *inter alia*, that “public transport services in South Africa will be based on regulated competition that will be in the form of permission, contract or concession awarded in terms of passenger transport plan and supported by strict law enforcement”. The White Paper defines the permission, contract and concession. Of interest to this study, however, is the mechanism of concessioning, which in terms of the policy is “the authority to operate a rail line or network at an agreed price between the operator and the authority” (Dept of Transport, 1996: 23).

It is essential to mention here that the framework for the provision of services precluded on-the-route or on-the-network competition especially in a situation where government funding support or subsidy would be involved. However, the policy did allow for on-the-route competition in a situation where profitable commercial services can be provided.

It is not the intention of this study to discuss the policy document. The policy document is, however, very important as it provides the basis for this study.

Furthermore, the White Paper provides an important policy direction for the commuter rail system. It is for this reason that the White Paper is quoted extensively in the background to this study.

To give effect to the White Paper, the National Land Transport Transition Act (NLTTA) (Act 22 of 2000) was passed by parliament with some parts coming into effect late in the year 2000. This Act (South Africa, 2000, s 21(1)) requires the Minister to publish the National Land Transport Strategic Framework annually in the *Government Gazette* in consultation with the Members of the Executive Council (MECs) of transport from various provinces. The National Land Transport Strategic Framework must include, among other things, a general strategy for rail transport including long distance passenger rail and a commuter rail concessioning strategy. It is hoped that issues affecting rail in general will be incorporated in the said strategy as is required by the NLTTA. It should be mentioned here that, in as far as commuter rail is concerned, the NLTTA places transport planning, including integrated transport plans, in the sphere of local government, specifically the transport authorities. However, the approval, for the rail component of transport plans compiled by such authorities will still be the responsibility of the Minister (SA, 2000, s 28). The White Paper has currently assigned ownership of commuter rail infrastructure, rolling stock and associated land reserves to the national authority until the province or transport authorities are ready to take over this responsibility. Challenges related to the rail concessioning mechanism will therefore arise irrespective of whether ownership of rail resides in the national, provincial or local sphere of government.

In addition to introducing new transport policy and the NLTTA, the Department of Transport embarked upon a “Moving South Africa Strategy”. The strategy noted that in the case of public transport about 35 percent of commuter trips in South Africa is undertaken on both rail and buses. These two modes receive a subsidy from the government or, as it is argued, the users of these two modes are subsidised. The minibus taxi industry is not subsidised and takes about 65 percent of commuter trips for public transport (Dept of Transport, 1998: 59).

This raises the question of value for money and affordability in the long term regarding rail and bus transport. The strategy confirmed the policy position to remove the deficit subsidy system and replace it with concessioning, especially for commuter rail.

1.1.3 Present South African commuter rail industry structural arrangements and some operational statistics

The South African Rail Commuter Corporation Limited (SARCC), which is responsible for the provision of commuter rail services, was established in April 1990. As mentioned earlier, it was established in terms of the Legal Succession to the Transport Services Act 9 of 1989. The SARCC falls under the control of the Minister of Transport and its board of control is composed of various members of the public, private business and the communities it serves. During 1992 SARCC formed a wholly owned subsidiary known as Intersite Property Management Services (IPMS) with a view to it managing the commuter rail property portfolio on its behalf (Dept of Transport & SARCC, 1996: 4–6).

The rail restructuring that resulted from the Legal Succession Act also saw the establishment of Transnet Limited. As mentioned earlier, the main shareholder in this company is the Minister of Department of Public Enterprises. Transnet comprises a number of core transport divisions like South African Airways, Spoornet, which provides mainly rail freight and other passenger rail services, Portnet, Petronet etc. Metrorail is mainly a commuter rail operator and provides this service on behalf of SARCC in terms of contractual arrangements between Transnet and SARCC. Prior to the current set-up, Metrorail was part of Spoornet, but was ultimately taken out of that stable. The original intention when both Transnet and SARCC were established was eventually to move Metrorail to the SARCC stable. The reason for not effecting this change at the time of establishment is that it was not possible to separate the systems, structures and employees of the national railway immediately (Dept of Transport & SARCC, 1996: 5-6). Currently, however, there are initiatives from the Department of

Transport to integrate Metrorail and SARCC, including the long-distance rail passenger transport services provided by Shosholoza Meyl. The organogram depicting the current structure of the rail industry and the ministries responsible is shown in Annexure 1.

Commuter rail services are provided in the major urban areas of Johannesburg, Pretoria, Durban, Cape Town, East London and Port Elizabeth (DOT & SARCC, 1996: 6). These services are currently provided under what is known as a “negotiated concession” between SARCC and Metrorail. The negotiated concession is contained in the “Memorandum of Agreement on the Repositioning of Metro” signed in December 1996 (SARCC & Metrorail, 1996: 2).

In as far as ridership is concerned, rail commuter journeys fell from 681 million in 1980/81 to 491 million in the 1999/2000 financial year and the share of commuter rail in the public transport market is estimated at 17 percent. The total subsidy bill in 1992/93 was around R1 180 million and increased to R1 594 million in the 1999/2000 financial year as a result of inflation (Dept of Transport, 2001: 74–76). Besides the low market share of commuter rail in the public passenger transport market and increasing subsidy as a result of inflation, there is funding challenge for aging rolling stock (SARCC, 2001: 10). It is a known fact that a large part of the commuter rail subsidy is used for operational purposes which leaves virtually nothing for investment in commuter rail infrastructure.

The Department of Transport and the SARCC (1996: 7) note that the current commuter rail deficit subsidy system is unacceptable and not in line with the principle of commercial discipline and regulated competition. They further note that, although the SARCC has achieved much since its establishment, there were still some inherent inefficiencies within the commuter rail system specifically when considering the fact that labour accounted for 70 percent of total operating costs and that there is still poor market responsiveness. The commuter rail passenger journeys, the percentage share of commuter journeys in the total public

passenger transport market and the state subsidies for commuter rail are included in Annexure 2 to this study.

1.2 Problem statement and purpose of the study

The shift in the government's policy of operating commuter rail services to the involvement of private operators through the concessioning mechanism will undoubtedly provide a significant challenge. The challenge emanates from the fact that this will be a new experience for the current authorities, the officials concerned, the rail industry and the various other stakeholders. The study envisages that concessioning will significantly alter the relationship between the operators and the authorities. Certainly, this will require firstly a fundamental knowledge of theories underlying the private and public sector and the challenges that are usually faced in a concession-type relationship. Secondly, it requires knowledge of cases where the concessioning mechanism has been practically implemented, specifically in the rail industry, so as to identify the associated challenges and the ways in which such challenges are resolved, and to put forward more effective solutions for the unique South African situation.

The goal of this study is therefore to develop a strategy for the concessioning of the commuter rail sub-system in South Africa.

There are two sub-goals that the study seeks to achieve and they are:

- To study the rationale for rail concessioning and the challenges arising from concession relationships.
- To investigate the rail economic regulatory environment with a view to understanding how to resolve the rail concession challenges.

1.3 Scope of the study

Concessioneering mechanism is applied in many parts of the world in various infrastructure projects like telecommunications, natural gas, electricity systems and transport infrastructure such as roads, ports, airports and railroads (Klein, 1998: 1). In South Africa, the construction of the Maputo development corridor provides an example in the case of road infrastructure.

It is reported that many members of the European Community and other states have undertaken far-reaching radical reforms in the rail industry (Wilson, 1999). In Latin America, in countries such as Brazil, Chile, Mexico etc, concessioneering in the field of rail is either operational or being finalised (Yash Pal Kedia, 2000). According to this source, the same is also true of sub-Saharan Africa for countries like Cameroon, Burkino-Faso and Gabon.

Klein (1998: 2) notes that most of the economic literature tends to use the word “franchising” instead of “concessioneering”. In this study, both words will be used interchangeably.

Franchising “involves conferring of rights in the supply or distribution of goods or services to a sole producer or operator for a specified period” (Domberger & Piggott, 1994: 51). This mechanism was conceived for a situation where competition within the market was not feasible or desirable. According to the source cited, natural monopolies (like rail), are obvious candidates for franchising. A further franchising mechanism was first enunciated by Chadwick in 1859 and was promoted as a serious alternative to regulation or nationalisation by Demsetz in 1968. According to these authors, in a Demsetz auction competition takes place by bidding for a franchise contract. The winner is the contestant who bids the minimum supply price (Domberger & Piggott, 1994: 52), that is, the contractor who undertakes to supply the goods or services at the lowest unit cost.

Two advantages of the concessioning mechanism are identified. Firstly, it gives the government time to decide on (total) denationalisation and, secondly, it helps to establish the comparative advantages that the enterprise has in the public or private sector environment (Ramanadham, 1988: 9).

After describing the fields in which the concessioning mechanism is actually implemented, including the origin of the concessioning tool and different perspectives on the meaning, this study is limited to commuter rail. This does not mean, however, that the commuter rail subsystem will be seen in isolation from the bigger rail system and the entire transport system. The Ministry of Public Enterprise released an Accelerated Agenda towards the Restructuring of State Owned Enterprises in August 2000. This policy framework also embraced the concessioning mechanism for the various units that are currently under Spoornet, which include among others, rail freight and long distance or mainline passenger services (Ministry of Public Enterprises, 2000: 6/12). In the background paragraph, the study also points out that the NLTTA requires the National Land Transport Strategic Framework to also include long distance rail concessioning. At the intercontinental level, this study includes rail cases of the UK, Argentina and Japan. The reason for selecting both the UK and the Argentine is that the two countries provide different options for rail concessioning from which wide experience can be drawn. Japan's experience is not concerned with concessioning per se, but with a privatised rail industry. This can be looked upon as an alternative in the long run.

1.4 Methodology

This study is mainly qualitative in nature. It relies extensively on an international literature study and empirical studies carried out particularly in the field of rail transport. The methodology comprises the following:

- A literature survey of the theoretical factors underlying the divide between the private and public sector enterprises

- An investigation of the theoretical foundation that underpins the identification of the challenges likely to emanate in the concession-type relationship especially in the rail industry
- A description of the railway challenges and strategies deployed at the international level to resolve the railway challenges experienced
- A description of the economic regulatory environment for liberalised railway systems
- In the case of South Africa this dissertation relies on consultation with employees of the institutions concerned and the official documents released. The lessons learned from the rail case studies provided in this study are included.

1.5 Arrangement of the chapters

This study consists of seven chapters, beginning with this introductory chapter. An introductory section is provided in each of the remaining chapters to describe the layout of each. At the end of each chapter a concluding section is provided.

In Chapter 2, the theory underlying the divide between private and public sector enterprises is investigated. The study investigates the theory in terms of the principal-agent approach. Various aspects like the X-efficiency theory and the contestable market theory are investigated.

Chapter 3 draws from Chapter 2. Owing to the difference in objectives between private and public sector enterprises, conflict may arise in the provision of commuter rail services by private sector rail concessionaires. The question is therefore what are the potential challenges that could emerge from such a concession relationship? Chapter 3 therefore investigates these potential challenges and broad ways of minimising such challenges are researched.

Chapter 4 investigates international experience. Countries that are selected include the United Kingdom, Argentina and Japan. The rail industry restructuring

in the first two countries consisted mainly of concessioning. This chapter also studies the rationale and the strategies deployed to concession the relevant rail systems.

Chapter 5 is concerned with the rail economic regulations. This is applicable in the case of liberalised rail systems including concessioned rail systems. The study examines the economic regulatory constraints and the price mechanisms that are usually applied in a concessioned rail system, including rate of return, price cap regulation, quality control and the underlying principle of access to rail infrastructure such as a rail network.

In the penultimate chapter, the study seeks to develop a commuter rail strategy especially with a view to the implementation of a concessioning regime for the commuter rail subsystem in South Africa. Various railway industry options are investigated. Other areas of the strategy are investigated such as strategy for concession agreements, strategy for risk-sharing arrangements, size of concession, duration, strategy for economic regulation, and strategy to assess the effectiveness of a commuter rail concession regime.

The last chapter contains the findings, conclusions and recommendations derived from this study.

1.6 Conclusion

In this introductory chapter, especially the section concerned with the background, a broad overview of the history of the South African rail industry was investigated. This was done to enable an understanding of and to put into perspective the evolution of the rail industry in South Africa. In as far as current transport policy is concerned, the National White Paper on Transport Policy has laid down the future direction of the rail industry. This does not mean that the government of the day cannot rescind such policy. Implementation could prove a daunting task for all the stakeholders especially if one takes into account that

traditionally the provision of commuter rail services has been undertaken by government agency. In as far as the technocrat is concerned concessioning of rail services requires an understanding of the economics involved.