

Why has Britain's railway privatisation not worked



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Introduction

As the wave of privatisation evolved, Britain's Railways were subjected to a shock vertical fragmentation. Initially, this paper briefly explores the distinguishing characteristics of the UK Railway industry. Secondly, it reviews the performance of the railways over 1948 - 1994, highlighting some of the failures of Railtrack and subsequently Network Rail. Finally, it addresses the main reasons for the failure of Britain's Railways. In conclusion, most commentators agree privatisation wrecked Britain's Railways. It led to the fragmentation of a historically loss making, subsidy dependant, capital intensive industry. There are some signs of a move towards regional integration, which could lead to some improvement. This option could have been implemented a long time ago, had political and economic ideologies been sidelined.

What makes the UK's Railway Industry different?

There are various characteristics of the rail industry, which over time have distinguished it from other utility industries. These characteristics make the imposed privatisation model inappropriate for it. Bartle (2004) suggested there are 4 main aspects of the UK's railway industry which set it apart.

Historically, the railway industry has always made a loss. The railway industry must be kept in business due the central role it plays in the UK economy. It also generates positive externalities and hence its role in social provisioning.

Significantly greater interface complexity is another feature which sets it apart from other utility industries. To some extent the interface complexity

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has been made worse by the vertical separation imposed on the industry. This has required effective coordination between the 100 different parts of the industry (Wolmar, 2002). For example, new trains must be compatible with the network's existing infrastructure.

Thirdly, in the south east of England, land scarcity due to the high population density has been a problem. Obtaining new land in the UK has been particularly difficult when compared to other countries and network industries. The need for land over time has put pressure on the development of the network and industry at large.

Finally, there has been a substantial increase in demand for railways over the years. Some commentators have argued no industry has faced such an explosion in demand as the rail industry since the mid 1990s. Demand has grown by over 40% over the past ten years, and is projected to grow by a further 30% over the next ten years (ORR, 2007).

Railway Industry between 1948 and 1994

Vertically integrated & Nationalised

The structure and regulation of Britain's Railway industry has been subjected to many policy changes. The 1948 – 1994 era marked Britain's Railways as a nationalised entity. British Railways (BRs) was setup in 1948 and followed a vertically integrated approach to rail management; it was divided into 6 regions London Midlands, Eastern, North Eastern, Western, Southern and Scottish (Hsiao, 2006). Responsibility of planning, investment, pricing, profits and integration of transport was given to the newly created British Transport Commission (Bartle, 2004). This nationalised, vertically integrated industry

structure aimed to take advantage of economies of scale, scope and eliminate abnormal profits. BRs performance in the 1980's showed it was the most financially successful railway in Europe, with a subsidy of 0.16% of GDP compared to the European average of 0.52% (Nash, 1994). In the 1980's it undertook various restructuring and reorganisation initiatives which enabled it to achieve productivity improvements and reduce its workforce by a third (Murray, 2005). One such initiative entitled "Organising for Quality" aimed to instigate greater financial responsibility and a decentralised approach to rail management. By April 1992, most changes were in place but so was the conservative government which belied radical plans for the railway industry.

Vertically fragmented & privatised

Privatisation was one of the radical plans of the conservatives and was not included in their 1979 manifesto. The justification for privatisation of BRs was based on what Crompton et al, (2004) called "abstract economic models", which disseminate from the public choice and property rights theories. Public choice theories argue public services are run in an inefficient way in the interest of its employees, rather than public interests. Property rights theories suggest public sector inefficiencies stem from weak property rights (Jupe, 2008). It was argued, at the time, that market forces would efficiently allocate resources and provide greater incentives for reducing costs, effective management and greater employee effort. Reducing the role of the government, raising revenue from the sale and reducing the public sector borrowing requirement were also amongst the most prominent arguments (Jupe, 2008). However, the main core reason for privatisation was on rail

competition, which would enable the achievement of some of the aforementioned arguments.

There were also various arguments against privatisation. Privatisation of network industries would merely transfer ownership from the public sector to the private sector and in effect, create a private sector monopoly. Further criticism was that state assets would be sold off at low prices, and as private entities focus on maximising shareholder wealth, investment on the network would decrease overtime.

It should be noted that although, economic models provided theoretical justifications for privatisation through enhanced efficiencies, empirical studies at the time produced mixed results at best (Crompton et al, 2004).

The chosen model for privatisation fragmented a historically integrated industry into a vertically fragmented industry. This model led to the creation of Railtrack as the infrastructure manager, 25 passenger train operating companies, 3 rolling stock companies, 13 infrastructure companies, and 6 freight companies (Wolmar, 2002). Railtrack was a profit maximising company listed on the London Stock Exchange, which reduced its permanent maintenance workers from 31, 000 in 1994 to a maximum of 19, 000 in 2000 through outsourcing (Jupe, 2008).

Railtrack was a natural monopoly with significant market power and the ability to control access to the rail network. In the interest of the industry and the public at large the Office of Rail Regulation (ORR) was created. ORR's main objective was and still is to ensure the industry is able to finance its activities, protect interests of consumers and promote competition.

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Another regulatory body was created in the form of Office of Passenger Rail Franchising, which allocated franchises and monitored TOC's performance. ORR periodically set the level of access charge paid by TOCs providing stable income for Network Rail. Access charges were crucial for Railtrack's profitability and the viability of TOC who were dependent on subsidies. The subsidy payments showed clear indirect public support to the private infrastructure owner.

Railtrack's Collapse

The demise of Railtrack came in October 2001 after the Hatfield crash, which highlighted the major flaws in the initial privatisation. Railtrack had focused on shareholder wealth maximisation over its public duty to maintain and renew its infrastructure. This focus had led to substantial outsourcing of maintenance and renewals. Over the whole of its existence, it never produced an asset register, which would have shown the condition of its infrastructure and its poor stewardship of assets. A policy of only replacing assets when needed replaced BR's traditional policy of replacing assets at set time intervals. Railtrack had no knowledge of its infrastructure condition and poorly managed its outsourced contracts. The need for an additional subsidy during the upgrading of the West Coast Main Line, forced a Labour minister to file for its bankruptcy.

Network Rail

Soon after the collapse of Railtrack, Network Rail, a not-for-profit public interest company was formed. A very similar industry structure to that under Railtrack was adopted. Members replaced shareholders but technically had no say in the business as they were appointed by the directors (Jupe, 2008).

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However, under Network Rail infrastructure costs have more than doubled. These are partly explained by the need to invest in infrastructure which was neglected under Railtrack. Network Rail's maintenance and renewal costs have increased substantially due to the increase in expenditure on track improvement and signalling. Its debt was £22 billion in 2008-2009, although its indemnity agreement has recently been removed, increasing public scrutiny (ORR, 2008).

Far from bringing costs and subsidies down, rail privatisation has led to an increase in costs, subsidies and borrowing. Subsidies to the industry have increased from £ 1 billion in 1986/87 to nearly £ 5 billion in 2008/09, with the government taking the brunt of almost 50% of the industry costs (Graph 1). This has mainly been due to increased safety costs, and interface costs as all the firms in the industry have tried to maximise profits.

Far from instilling private sector discipline, Network Rail's structure has managed to keep costs of the railway away from the governments' balance sheets. Efficiency savings from bringing maintenance back in house have yielded less than £100 million (Bartle, 2004). Until 2006, Network Rail had failed to create an asset register. To offer a different perspective, the CEO of National Express Train division suggested that the regulation of Network Rail by ORR over costs was not as stringent as the regulation of TOC by OPRAF (Crompton et al, 2004).

Graph 1 – Industry Revenues & Subsidies since 1986/87 – 2008/09

Source: Adapted from Department of Transport, 2010

Reasons for the Failure of Privatisation

There are various reasons which may explain why privatisation of the railway industry has not worked. This section highlights some of the major arguments which have featured in the literature analysis.

Firstly, Wolmar (2002) and Bartle (2004) suggest private ownership of an industry that provides a public service which is heavily subsidised and is a natural monopoly is flawed from the onset. The major flaw in the initial model of privatisation stems from having a profit maximising entity at the heart of an industry that provides a service for society as a whole. Society benefits economically and environmentally from an efficient railway industry.

The demise of Railtrack illustrated the incompatibility between private ownership and a heavily subsidised industry. Private ownership has not only led to public money being paid for dividends, but rail companies are also aware of the implicit bailout clause, should they face financial distress. The subsidies paid by government have been mainly due to the historic under investment in the industry, which were not effectively used for investment on the tracks. This was illustrated by the Hatfield crash.

It could be argued private ownership led to a principal-agent problem. There were clear conflicts of interest, which were not solved by incentivising the agent. Railtrack focused on shareholder wealth maximisation, despite its public obligation set by the principal, ORR, to maintain and invest in the railways. In addition, private ownership of a natural monopoly enabled Railtrack to exercise its market power. To some extent, it could be argued that the principal-agent problem may have diminished under Network Rail,

as shareholders were replaced by industry stakeholders. However, these stakeholders had no financial or economic interest in Network Rail. Most of these stakeholders tried to maximise individual profit. Hence, it may be suggested market forces did not really instil the market discipline they were supposed to bring about under private ownership. Rather they led to a process of double marginalisation at the expense of the public.

Perhaps the most compelling argument identified in the literature which may explain the unsuccessful privatisation of the rail industry is fragmentation (Wolmar, 2002, Bartle, 2004, & Murray 2005). The imposed privatisation model separated the infrastructure manager from the TOCs and maintenance operations. The process of maintenance which was outsourced initially, illustrates the level of fragmentation: first Railtrack would be informed if a rail needed replacing, Railtrack would judge whether renewals were required due to age or maintenance, then it would inform the renewal company which would finally coordinate with Railtrack (Bartle, 2004).

Fragmentation led to a loss of institutional knowledge as Railtrack reduced its workforce and replaced it with outsourced maintenance contracts.

Although Network Rail brought maintenance back in-house, the costs have increased substantially as fragmentation had meant the infrastructure manager's maintenance obligation was not fulfilled from the onset.

Unsurprisingly, Network Rail's operating, maintenance & renewals expenditure have increased from £ 3billion in 1995/1996 to a peak of £ 6billion in 2003/2004 (Graph 1).

Graph 1: Operating, Maintenance & Renewal Expenditure on the railways.

Source: Adapted from ORR (2008)

Interface complexities and the need to have close technical integration made fragmentation worse. Catalyst (2004), adds further support to this argument by suggesting since the initial privatisation there was a lack of strategic coordination between the different players in the industry. What adds more weight to this argument, is that the industry underwent a “ shock” reform in comparison to that of other utilities which meant it was never able to iron out coordination problems until Network Rail brought maintenance back in. It was only in the 2008 periodic review that ORR attempted to tackle this problem by financially incentivising both Network Rail and other service providers in the industry.

However, Pollitt (2001) argued fragmentation may not have necessarily been bad for the industry, rather the excessive rate at which privatisation was undertaken. Moreover, it could be argued the loss of experienced staff could have happened under BR (Bartle, 2004).

Regulatory failure has been another reason for the failure of the privatisation of the railway industry (Murray, 2005). Techniques of good regulation used in other utilities were not effectively implemented in the rail industry especially in the early days of privatisation. Regulation was not targeted directly at investment initially. Railtrack only invested in infrastructure due to the financial incentives it received and using the access charges from the TOCs. The regulation philosophy initially focused on enforcing contracts over economic regulation. Murray (2005) also suggests rail privatisation may have failed as Railtrack was over regulated. Tom Winsor, the third regulator of

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Network Rail also conceded, “ The contractual regime at the time of privatisation malfunctioned too badly and too often” (cited in Bartle, 2004).

In addition, initially there was no meaningful comparison to Railtrack to assess its relative performance, as the UK was first to experiment privatisation. The regulator measured performance based on Railtrack's ability to meet set targets, thus a modified RPI-X price cap regulation was used (Smith, 2003). Three regulatory bodies were created initially, leading to a confused relationship between ORR, SRA and the safety regulator.

However, over the years regulatory failure has diminished. ORR adopted best practises from other utility regulators using both engineering and econometric techniques in setting the revenue requirement and for potential efficiency improvements. Moreover, ORR has also more recently begun comparing Network Rail's performance with that of other international railway managers, although direct comparisons are still difficult to make given the structural differences between train managers.

Finally, no utility industry has undergone such a radical privatisation in such a short period of time. Murray (2001) suggests “ haste added to the combustible cocktail of ideological intransigence and greed” (pp. 7).

Privatisation was undertaken quickly to ensure privatisation was irreversible. This big bang approach exacerbated some of the flaws of privatisation as it made on rail competition unworkable, if at all achievable. Comparing the British privatisation to the Swedish privatisation shows that a gradualist incremental deregulation of the railways would have been much more effective and may have achieved the economic goals of privatisation.

Moreover, Glaister (2004) suggests introducing competition in the railways could have worked, if and only if, it was set up correctly and then left unmolested by political ideologies. However, the quick privatisation was in effect politically motivated and so have the subsequent reforms overtime.

On the other hand, it may be argued that privatisation of the rail industry may not have been that bad. According to Pollitt & Smith, (2002) Railtrack's performance pre-Hatfield had improved, accident rates were down, efficiency was up, reliability and punctuality improved too. Their arguments also suggested passenger miles, train miles and freight usage had risen sharply since privatisation. Moreover, Railtrack's costs were falling and it was performing better than BR. To support this notion several academics argued that the initial problems were merely teething problems which would iron out over several years. However, it is difficult to empathise with this argument as several years after the initial privatisation problems were still occurring and continue to date (Bartle, 2004). 2006-2007 was the only year in which there were no accidents on the British mainline.

Pollitt & Smith (2002) also went on to show that the output quality under BR in the post-Hatfield era would have been equally poor in terms of efficiencies and performance. However, this argument holds little substance, as the cost dataset used in their analysis has been questioned (Bartle, 2004). Besides, BR was vertically integrated, fully managed its maintenance and had better knowledge of its infrastructure conditions, compared to Railtrack. Hence, Railtrack was simply living on borrowed time, having failed to invest in its infrastructure (Smith, J, 2004).

Graph 2 suggests that performance under Network Rail has improved.

Network Rail endeavours to meet ORR's tougher performance measures on safety, delays, and cancellations amongst others, at the same time increasing its capacity, to accommodate increasing demand (Graph 3).

Graph 2 – Train reliability (Public Performance Measure since privatisation)

Source: Adapted from Department of Transport, 2010

Graph 2 – Rail Passenger Trips in millions since 1999/2000 – 2006/2007

Source: Adapted from Network Rail, 2007

Industry today and in the future

It's pertinent to address a central question: has the increase in cost of the railways matched the increase in its outputs? On the one hand improvements in safety, performance, a better freight network, increased demand and better regulation. But these may have happened anyway (Tyrrall, 2004). The on-going McNulty Review (2010) suggests that despite the increase in the growth of the industry, the overall cost of running the railways has increased and given the current spending constraints, the existing railway may become unaffordable. Hence, one is forced to suggest that improvements have come at a price.

Costs of rail fares have more than doubled, yet subsidies to the industry have increased. This suggests the cost of privatisation has been greater than the savings that competition and privatisation may have brought about. The cost has been too great because the model of privatisation did not strategically match the UK's railway industry. As credible chances to

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renationalise the railways have gone by, it can be suggested political and economic ideologies have been at the forefront than the exquisite understanding of the industry, onto which economic models could have been applied.

Russell (2010) recently revealed that the new CEO of Network Rail intends to divide up the tracks into 9 regional areas; before such integration is called for by the ORR and the government. Such a regionally integrated model existed previously until such a “fudged”, “silly scheme” was imposed. This potential structural change may just underpin the political and economic realisation that fragmentation and vertical separation has not been successful over the past two decades. It also leads one to suggest, perhaps a Japanese privatisation model may be adopted in the future. This could have potentially been adopted much earlier, if only ideological differences could have been set aside.

Conclusion

Britain's Railway industry has moved from a vertically integrated to a vertically fragmented industry as the wave of privatisation swept through. Despite increasing demand, improvements in safety and performance, the cost of running the railways have increased substantially. Most people will agree with Wolmar (2002), “privatisation, and privatisation alone, wrecked Britain's railways”. However there are various explanatory variables that have contributed to this failure including, fragmentation, regulatory failure, private ownership and speed. Fragmentation of a loss making, subsidy dependent, capital intensive industry has by far been the biggest let down of the poorly conceived privatisation model. It remains to be seen if the

industry will ever move to a vertically integrated model. But even then, an appropriate regulatory regime will continue to remain essential and second best (Saal, 2003).