

The impact of britains railway privatization economics essay



**ASSIGN
BUSTER**

As the wave of privatisation came to an end Britain's railways were subjected to a shock vertical fragmentation (Murray, 2005). Initially, this paper briefly explores the distinguishing characteristics of the UK railway industry. Secondly, it reviews the performance of the railways in the period 1948 - 1994, and 1994 onwards; in doing so it highlights some of the failures of Railtrack and subsequently Network Rail. Finally, it addresses the main reasons for the failure of Britain's railways and questions whether privatisation really was a force for bad. In conclusion, most commentators agree privatisation wrecked Britain's railways (Bartle, 2004). It led to the fragmentation of a historically loss making, subsidy dependant, and 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 (Jupe, 2009).

What makes the UK's Railway Industry different?

In contextualising this essay, Bartle (2004) notes that there are various historic characteristics to the British rail industry which, in his opinion, made its privatisation inappropriate. In expanding upon these characteristics, he firstly points to its central role as a method and means of infrastructure and its role (in that guise) as a provider of positive externalities. Thereafter, he suggests that the industry possessed far greater interface complexities than those of comparable industries that were privatised under the Conservative Governments of the late 1970s to late 1990s and that these have been made worse by the vertical separation that privatisation imposed on the industry. This is because it required, as Wolmar (2002) also notes, effective

coordination between the 100 different parts of the industry. Bartle (2004) also contends that in the south east of England, land scarcity has hampered the development of the network. A final feature Bartle (2004) suggests is the increasing demand the rail industry faces. The Office of Rail Regulation (ORR) (2007) suggests 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.

Railway Industry between 1948 and 1994

Vertically integrated and nationalised

British Railways (BR) was setup in 1948 and followed a vertically integrated approach to rail management; it was divided into six regions London Midlands, Eastern, North Eastern, Western, Southern and Scottish (Wolmar, 2002). Responsibility for planning, investment, pricing, profits and integration of transport was given to the newly created British Transport Commission (Bartle, 2004). This vertically integrated industry structure provided coordination economies of scale and scope whilst eliminating abnormal profits. BR performance in the 1980s 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 1980s it undertook various restructuring and reorganisation initiatives that enabled it to achieve productivity improvements and reduce its workforce (Murray, 2005). One such initiative entitled "Organising for Quality" aimed to instigate greater financial responsibility and a decentralised approach to rail management. Given these preliminary successes it could be argued that there was no need for the industry's privatisation as it was an industry fulfilling its expectations (Crompton et al, (2004).

Vertically fragmented & privatised

The justification for privatisation of BR was based on what Crompton et al, (2004) called abstract economic models, which had its theoretical basis within 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 whilst property rights theories suggest public sector inefficiencies stem from weak property rights (Jupe, 2009). 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 (Shaul, 1997).

Consequently, as Jupe (2009) notes, reducing the role of government, raising revenue from the sale and reducing the public sector borrowing requirement were also amongst the most prominent arguments deployed by those in favour of privatising BR. The Major Government's main core reason for privatisation was on rail competition, which would enable the achievement of some of the aforementioned arguments. However, Gourvish (2002) notes this was the most riskiest and ideological privatisations to date.

On the other hand it was argued, by Nash, (1990) that privatisation of network industries would 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 <https://assignbuster.com/the-impact-of-britains-railway-privatization-economics-essay/>

studies at the time produced mixed results at best (Crompton et al, 2004). In particular Preston (1996), argued that there was only limited economic evidence justifying the horizontal separation of the rail industry and called for a cautionary approach to railway reform.

The chosen model for privatisation fragmented a historically integrated industry into a vertically fragmented industry. The model adopted led to the creation of Railtrack as the infrastructure manager, 25 passenger train operating companies (TOC), 3 rolling stock companies, 13 infrastructure companies, and 6 freight companies (Wolmar, 2002). 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. 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. These access charges were indirect subsidies required for Railtrack's profitability and the viability of TOC.

Railtrack's Collapse

The demise of Railtrack came in October 2001 after the Hatfield crash, which highlighted major flaws in the initial privatisation. Railtrack had focused on shareholder wealth maximisation over its public duty to maintain and renew its infrastructure (Jupe, 2002). It appears this focus had led to substantial outsourcing of maintenance and renewals. Bartle, (2004) suggests over the <https://assignbuster.com/the-impact-of-britains-railway-privatization-economics-essay/>

whole of its existence, it never produced an asset register detailing the condition of its assets, which would have highlighted its poor stewardship of the company's assets. The need for an additional subsidy during the upgrading of the West Coast Main Line set of a turn of events that lead to its bankruptcy.

Network Rail

Soon after the collapse of Railtrack, Network Rail, a not-for-profit public interest company was formed in 2002 (ORR, 2008). In commenting upon the nature of its formation, Bartle (2004) notes that a very similar industry structure to that under Railtrack was adopted and that whilst members replaced shareholders they, nevertheless had no say in the business as they were appointed by the directors. However, under Network Rail infrastructure costs have more than doubled (DfT, 2008). 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 £ 1billion in 1986/87 to nearly £ 5billion in 2008/09, with the government taking the brunt of almost 50% of the industry costs (Graph One). This has mainly been due to increased safety costs, and interface costs as all the firms in the industry have tried to maximise profits. Moreover, far

from instilling private sector discipline, Network Rail's structure has
<https://assignbuster.com/the-impact-of-britains-railway-privatization-economics-essay/>

managed to keep costs of the railway away from the governments' balance sheets and thus the hoped for benefits to the Exchequer have not been realised. This is because efficiency savings from bringing maintenance back in house have yielded less than £100 million (Bartle, 2004).

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

Revenues & Costs 1987 - 2009

Source: Adapted from Department of Transport, 2010

Reasons for the Failure of Privatisation

There are various reasons that may explain why privatisation of the railway industry has not worked. Firstly, Wolmar (2002) and Bartle (2004) suggest that private ownership of an industry that's providing a heavily subsidised public service, that is also a natural monopoly, will be 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 providing a service for society as a whole. Jupe (2009)'s financial analysis shows private ownership of the railways has led to public money being paid for dividends. Governmental subsidies were arguably provided due to the historic under investment in the industry, in track building and maintenance; yet were ineffectively used. 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 (Bartle, 2004). To some extent, it can, consequently, 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 that of fragmentation (Wolmar, 2002, Bartle, 2004, & Murray 2005). The imposed privatisation model separated the infrastructure manager from the TOC 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). This is important to note because fragmentation led to a loss of institutional knowledge as Railtrack reduced its workforce and replaced it with outsourced maintenance contracts (Murray, 2005). 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 Two).

Graph 2: 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 (Bartle, 2004). 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 vertical separation may not have necessarily been bad for the industry, and alternatively posits that the excessive rate at which privatisation was undertaken was the key problem. 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. Bartle, (2004) argues Railtrack only invested in infrastructure due to the financial incentives it received and using the access charges from the TOCs. ORR has only recently begun providing incentives for investments and setting quality parameters. 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 Network Rail also conceded, “The contractual regime at the time of privatisation malfunctioned too badly and too often” (cited in Bartle, (2004, pp. 55).

Initially, there was no meaningful comparison to Railtrack to assess its relative performance, as the UK was first to experiment privatisation. 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 (ORR, 2008). ORR now compares Network Rail’s performance with that of other international railway managers; however, one points to the pendulum of debates on productivity and efficiency improvement targets between ORR and Network Rail to highlight the difficulty in making direct comparisons.

Finally, no utility industry has undergone such a radical privatisation in such a short period of time. Murray (2001, 7) suggests “haste added to the combustible cocktail of ideological intransigence and greed”. Privatisation was undertaken quickly to ensure privatisation was irreversible. This shock 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 <https://assignbuster.com/the-impact-of-britains-railway-privatization-economics-essay/>

deregulation of the railways would have been much more effective and may have achieved the economic goals of privatisation (Bartle, 2004). Moreover, Glaister (2004) suggests that introducing competition to the railways could have worked, if and only if, it had been 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.

However, it is alternatively contended that privatisation of the rail industry in the UK was not a force for 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 suggest 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 Curwen, 1997 argued that the initial problems Railtrack faced were merely teething problems which would be 'ironed out' as privatisation settled. 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). Indeed, 2006-2007 was the only year in which there were no accidents on the British mainline. Pollitt and Smith (2002) also 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, 2004).

Graph Two 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 Three).

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

Train reliability

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

The rail industry today and conclusion

It is 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 have been achieved. 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.

Indeed, costs of rail fares have more than doubled, whilst subsidies to the industry have also increased. This suggests that 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 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 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 a 'fudged', privatisation programme 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.

Thus this essay has shown that Britain's railway industry has moved from a vertically integrated to a vertically fragmented industry as a consequence of privatisation. Moreover, despite increasing demand, improvements in safety and performance, the cost of running the railways have increased

substantially. Such is the level of contention regarding the success of the privatisation programme that Wolmar (2002) has even gone so far as to <https://assignbuster.com/the-impact-of-britains-railway-privatization-economics-essay/>

suggest that “ privatisation, and privatisation alone, wrecked Britain’s railways” (pp. 1). However, there are, as noted within this assignment, alternative opinions to this and there are additional explanatory variables that have been proffered to explain the industry’s difficulties. These include issues of, fragmentation, regulatory failure, private ownership and speed and each of these has been both contextualised and discussed within this assignment. In so doing, two final conclusions are advanced. First, that, the fragmentation of a loss making, subsidy dependent, capital intensive industry has by far been the biggest let down of the poorly conceived privatisation model. Second, that it remains to be seen if the industry will ever move to a vertically integrated model; but as Saal (2003) posits an appropriate regulatory regime will remain essential and second best.