

No Way to Run a Railway

Lessons from British Rail Privatization

by

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Much of this paper would not have been possible without Christian Wolmar's survey, *"Broken Rails: How Privatisation Wrecked Britain's Railways."* Although this paper comes to a different conclusion, Christian Wolmar's book is invaluable as a primary source of comments and insights from those most involved in privatization as well as a good general narrative of the process.

Bibliographical information

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Contents

Executive summary	4
1. The political and regulatory history of Britain's rail system	5
2. Privatization and restructuring of the rail system in Britain	10
3. Accidents, political interference, and financial collapse	14
4. The confused structure of the post-Railtrack industry	17
5. Analysis — what went wrong?	21
6. Lessons from rail deregulation in the United States	28
Appendixes	
1: <i>Project approval and political risk: Crossrail and Central Railways</i>	33
2: <i>The European dimension: European Directive EC 91/440</i>	34
3: <i>The Hatfield derailment and its consequences</i>	35
Notes	37

Executive summary

The history of Britain's rail industry is one of persistent abuse by government. From Gladstone's "Parliamentary Train" to the glut of regulations surrounding today's rail industry, the hand of government has rarely been absent in the running of the railways. This has caused significant problems for railway operations and infrastructure maintenance.

Contrary to most people's perceptions, the sorry state of today's railways was caused not by privatization but by a long history of government interference and control. Privatization presented an opportunity to break the vicious cycle of underinvestment that led to degraded performance, but the opportunity was not taken.

The problems of an over-complex structure which the government forced on the industry at privatization were exacerbated by an inappropriate regulatory structure. This was worsened by the current government's expansion of regulatory powers coupled with the forced re-nationalization (in all but name) of Railtrack.

The present railway industry cannot be called privatized in any meaningful sense. The combination of regulatory structure and public ownership of the track and station infrastructure makes it impossible for the private sector operators to employ genuine private-sector disciplines and strategies in improving the service to travelling customers.

At the very least, the railway needs to be reintegrated to allow operators more control over the service. This will make for more efficient investment decisions and a better allocation of resources towards providing the services that the customers want.

At the same time, the regulatory burden must be lightened. In this case it is helpful to learn from the experiences of the American railroad industry after deregulation occurred in 1980: services expanded, infrastructure investment increased and the economy benefited considerably.

It is time for the UK to look again at what is best for the railways. The mistakes of the 1990s should not be repeated; but the dead hand of regulation is a worse answer. The railways can benefit from privatization, properly implemented: so it is about time that this option was really given a chance.

1. The political and regulatory history of Britain's rail system

After George and Robert Stephenson opened the first operational railway in world history, between the northern industrial towns of Stockton and Darlington in 1825, the British rail system exploded into life. By 1852, significant infrastructure had been created, with 6600 miles of track. As Robert C B Miller explains in *Railway Dot Com*,¹ this paralleled the recent internet boom, as speculators and banks rushed to fund the new technology, despite the lack of any proven business model. Speculation also occurred despite a project approval process that required Acts of Parliament to secure the powers needed to build the railways. When the dust settled in mid-century, many of those banks and speculators had gone bust, but Britain had an infrastructure network that would serve its needs well throughout the heyday of rail travel, before the arrival of motorized road transport.

Early moves to regulate rail

It was not long after the opening of the first railway before the government started to interfere in the business of the railways. Perhaps it was unfortunate that the first man ever to die in a public railway accident was a prominent member of parliament and cabinet minister, William Huskisson, killed by an engine on the other line while taking a break from a trip on the Duke of Wellington's train in 1830. Yet it still took another ten years before the Regulation of Railways Act 1840 set about the creation of a safety regulator, followed by eight similar acts over the next 50 years, often following accidents such as the "Armagh Disaster" that killed 88 in 1889.

Alongside safety regulation, economic regulation strengthened during the Victorian rail heyday. The Duke of Wellington, a shameless reactionary who feared that the railway "encouraged the common people to move about the country," had suggested state control of the railways. In 1859, following some shady deals and bankruptcy scandals, and motivated by the opposite desire to guarantee public access, Gladstone's Liberal government drew up plans to impose strict economic control and even to nationalize certain lines, although the plan was watered down before Parliament enacted it (powers were granted to buy certain lines in the case of excess profit, but these were given up on the recommendation of a Royal Commission in 1867).

Yet Gladstone did succeed in distorting the market in a manner that set the tone for later government interference. He instituted the Parliamentary Train, a service mandated by Parliament to serve third-class travellers at a fare not to exceed one penny per mile. These services, because they were poorly timed, actually deterred third class passengers (who would have been more likely to travel at other times but were reluctant to use the more expensive services after the introduction of the mandated train), but the principle of a public rail service mandated by government had been established. It would never cease to be a part of the industry.

Nevertheless, the industry thrived during the Imperial heyday, employing 648,000 people in the late Victorian age. Yet, as Christian Wolmar says:

The beginning of the decline of the railways coincided with much greater government involvement as the state took over the running of the system in 1914 after the outbreak of the Great War, using powers under the Regulation of the Forces Act 1871. The war was to change the management of the railways forever. The railways, which had reached their peak size of 23,000 route miles, were expected to shoulder the overwhelming burden of transporting materials, munitions and people, and this could only happen with government control. While it would be simplistic to argue that it was the government's greater role which damaged the railways [during the war], the state that the network was left in after the war was to cause insuperable problems for the industry in the ensuing decades. The railways were sweated and over-used, with very little compensating investment since resources were concentrated on the war effort. The railways had been run into the ground, with a major backlog of maintenance and equipment, and administrative chaos.²

These issues — overuse of assets owing to government insistence, maintenance backlog, investment shortfall and administrative chaos — were to come up again and again as years went on. As we shall see, they are dominant again today.

Government re-shaping of the industry

The government's, "helping hand", to the industry it had helped grind down, was simply to force market consolidation via the Railways Act 1921, aimed at increasing national efficiency by reducing "wasteful rivalry", as Wolmar puts it. The Act created the "Big Four" companies on a geographic basis: the London & North Eastern Railway (LNER), London Midland & Scottish (LMS), Southern, and the Great Western Railway (GWR). The government was also granted the power to fund major investment schemes. In an echo of American rail regulation, the government both began regulating freight rates in order to return them to the pre-war levels of 1913 whilst also forcing them to become "common carriers", obliging them to undertake certain services on demand, whether or not they would make a profit.

This new regime proved, as Wolmar admits, "a recipe for disaster". Passenger and freight traffic declined; freight traffic in particular suffered as road trucks began to attract business away. Wolmar summarizes:

The Big Four's twenty-five year existence can be characterized as an unsuccessful struggle to achieve profitability which, in turn, meant that the system suffered badly from under-investment. The government's promise, when it forced through the grouping of the Big Four, to maintain the companies' net receipts at 1913 levels through

the regulation of charging rates proved impossible to fulfil, given the fast-growing competition from other forms of transport which meant that the 1913 targets were hardly ever met... Passengers, too, were no longer prepared to put up with shoddy service away from the main lines with corridor-less trains that provided neither toilets nor refreshments.³

The Big Four launched a campaign in 1938 aimed at reducing government regulation, something the then government of Neville Chamberlain had some sympathy for, but the Second World War intervened before any deal could be reached. The railways' experience during this conflict sadly mirrored that during the first. Overuse, lack of maintenance and investment and ramshackle administration wore the state of the industry down further.

A soft target for post-war control

Thus, the railways were a natural target for the post-war Labour government led by Clement Atlee, it aimed to improve efficiency by bringing industry under the all-knowing control of Whitehall bureaucrats.⁴ The British people had become used to command-and-control during the extraordinary circumstances of six years of war, so it seemed natural to them to extend the principle to peacetime. Alongside so many other industries, from coal mining to healthcare, Britain's railways were formally nationalized in 1948.

The resulting nationalized industry, British Railways (BR), was controlled by the British Transport Commission (BTC) and was appointed by the Secretary of State for Transport. Funding was determined ultimately by the Treasury, whose annual public expenditure budget generally passed through Parliament as a formality owing to the nature of the political process. BR's service revenues and income from other interests such as property could be supplemented from public funds, but BR had to compete against all the other public expenditure commitments that the government had undertaken. The industry's revenues were never enough to cover both its operational costs and the cost of infrastructure upgrading and improvement. When pitted against the need for new hospitals or increased welfare payments, the rail industry normally lost in the battle for additional expenditure. This inevitably led to a series of financial crises.

The Beeching cuts

With the rise of alternative means of transport, the rail industry was increasingly saddled with a bloated infrastructure, yet obliged to run large numbers of loss-making services. The inevitable result was the "Beeching cuts," named after Dr Richard Beeching, appointed Chairman of the BTC in 1962 by Transport Minister Ernest Marples with the explicit task of solving BR's financial problems.⁵ Beeching drastically streamlined the network, proposing to close down 2,363 stations and thousands of miles of track.⁶ In the end only 10,500 miles of track survived (Beeching had wanted to reduce the amount to 7,500, with only 3,000 of that in intensive use).

Yet the post-Beeching railway still operated on socialist economic theory. Each passenger service was analyzed to see if there was enough of a “social case” to justify government subsidy of a loss-making service. For example, if a service provided social benefits to a community that had a small proportion of car owners, but whose labour force was predominantly employed in a nearby town served by the rail connection, then BR would accept a Public Service Obligation (PSO) to maintain the rail connection with losses subsidized by central government. As a result, even the drastically reduced network continued to face financing problems. The problem was summarized by BR official historian, T R Gourvish as follows:

The BTC had wanted to modernize the railways after years of neglect. The public wanted a modern railway network of roughly the same size of 1955. The government wanted the BTC to fulfil its obligation to break even. Much of the review activity was ... about the attempt, made under government pressure, to reconcile these objectives. Not surprisingly, it proved impossible to do so.⁷

As Wolmar says,

He was writing about ... Beeching but this analysis could apply equally to any part of the past fifty years of railway history.⁸

Slowly getting BR into shape

The industry continued to stagger on though the 1960s, '70s and '80s, becoming, in the process, a national joke. The quality of the service — from delayed trains to the infamous “British Rail sandwich” (a meagre slice of ham between two curling pieces of cardboard that might once have been bread) — was the staple of complaints among commuters, in newspaper columns and on satirical TV comedy shows.

This steady diet of problems led to another restructuring in 1982, when the old geographic structure was replaced by a series of stand-alone, but still government-owned, businesses — InterCity, Network SouthEast (rebranded as such in a blaze of publicity in 1986), Regional Railways and separate freight and delivery businesses. The managers of these new organizations were, at last, “expected to run them like commercial concerns by taking responsibility for marketing, investment and cost allocation.”⁹

This new discipline, coupled with a friendly relationship between BR Chairman Sir Bob Reid and Mrs Thatcher’s Transport Secretary, Nicholas Ridley, led to a turnaround in the railways’ fortunes. InterCity turned a 1984 loss of £100 million to significant profits in the late 1980s. Network SouthEast invested large sums but still broke even after initial losses. Fares were allowed to increase at rates higher than inflation to levels the market would bear. As Wolmar summarizes:

Through a combination of tight management under a good run of chairmen and some, though insufficient, investment, BR had largely got it right. The management had finally got rid of the regional baronies, they had developed a competitive — or market-orientated — fares policy, strikes were reducing, the passenger's charter had been developed as a means of measuring performance — which was improving — and they had even convinced the government to allow rolling stock to be leased. ... efficiency was the best in Europe and productivity still rising. British Rail bore comparison with any major railway operation in the world.¹⁰

So, the fact that the industry was improving was no doubt a factor in the minds of those who were suggesting that it could be fully privatized (although critics to this day persist, perversely, in insisting that the industry's improvement was a reason why it should not have been privatized). It is to the thinking surrounding privatization that we shall turn next.

2. Privatization and restructuring of the rail industry in Britain

A simple set of assumptions provided the rationale for the British privatization wave of the 1980s and '90s. The Conservative government recognized that public control of industry was both wasteful of public money and inefficient, because it suppressed the constant pressure for innovative approaches that private sector management requires in the search for sustainable competitive advantage. Privatizing industries would reduce the public expenditure burden, freeing up room for tax cuts, and at the same time make British industries more competitive in the world markets. These effects would boost Britain's economy.

Structural questions

Efficiency arguments applied as much to the rail industry as they did to any other utility. The question that had delayed privatization was what model would be used to create an appropriate industry structure. Many British privatizations, such as those of British Telecom, British Airways or British Steel, had merely taken a monopoly or near-monopoly service provider, and removed its monopoly powers while selling the company, via stock market flotation, virtually intact. New markets had been created (or re-created) by the removal of monopoly powers, while regulators had been put in position where necessary to help "make the markets" and ensure that the privatized firms did not abuse their market dominance to reassert a monopoly position. By and large, this model had worked.

However, in the case of utility privatizations, the experience with British Gas, privatized as one monolithic supplier, had suggested that monopolistic tendencies created severe challenges for regulators attempting to guarantee a competitive market (eventually, British Gas split itself into two companies in response to regulatory measures).

The government therefore attempted to "jump start" the competitive process by breaking up nationalized utilities, whether it was by the creation of regional companies (as in privatization of the water supply industry), or the restructuring of the utility into competing companies with a substantial element of vertical separation. A prime example of the latter was the electricity generation and supply industry, where the Central Electricity Generating Board and its regional supply boards were restructured into four companies. The transmission system was transferred to the National Grid Company. Two generating companies were created in direct competition with each other. The 12 area supply boards were superseded by 12 Regional Electricity Companies, which were given a licence to distribute and supply electricity within their own areas.

The utility privatizations, however, proved problematic, illustrating that regulators are not really in any position to decide on an appropriate structure for an industry. There was therefore considerable debate as to how BR privatization should proceed. There was fairly swift agreement that the organization should not be privatized as a monopoly, given the significant entry barriers entailed in provision of vertically integrated rail services (it was and remains extremely difficult to gain approval to build an independent railway). Splitting the companies into the various operating areas of BR would also prove problematic, as Regional Railways, which required by far the most subsidy, would be very much a poor relation to the profitable InterCity and solvent NetworkSE divisions. Later events, however, demonstrated that these options were abandoned perhaps too quickly.

Initially, thinking ran along the lines of water privatization with the creation, or rather re-creation, of the old regional companies, which would compete against each other in a limited fashion. The industry would remain vertically integrated in this option.¹¹ However, there were worries that the level of competition would not be enough to deliver the service improvements felt necessary. There was also an important European dimension to the issue (see Appendix 2).

A scheme was therefore devised, based on outline proposals from the Adam Smith Institute in 1987,¹² which would introduce competition into the industry by means of “competitive tensions” created by contracts between operating units and their need for regular renegotiation at the optimum level of benefit for all parties. This would be done primarily by means of vertical separation.

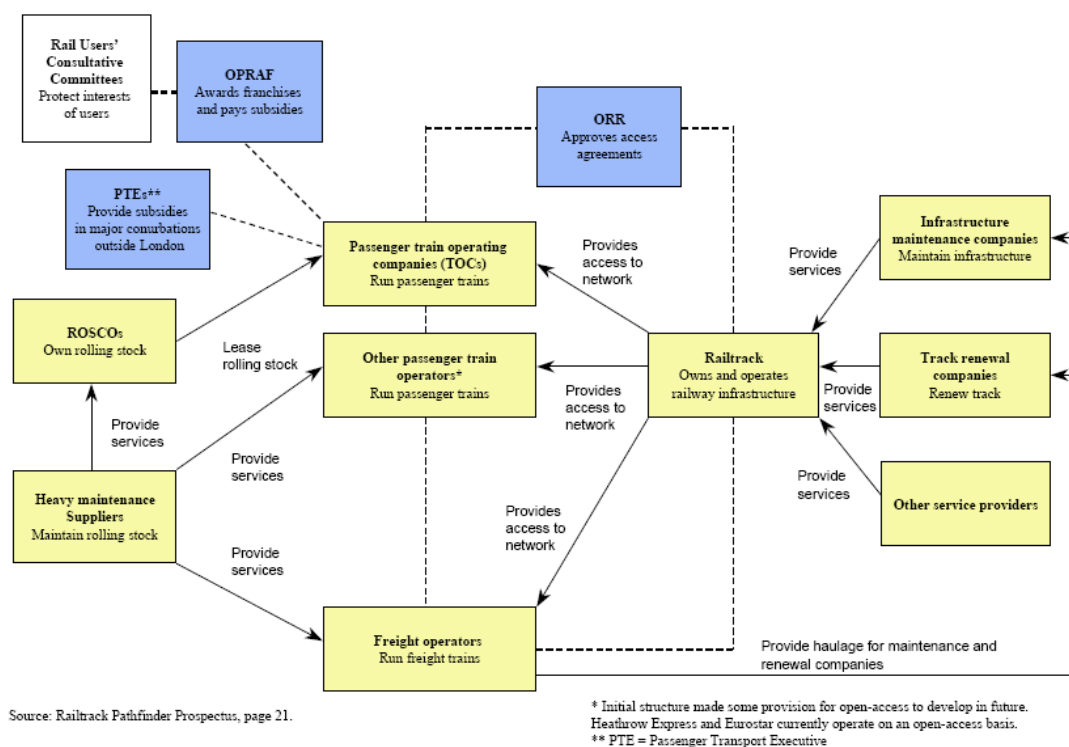
Fragmentation, not competition

The practical implementation of these proposals however produced a highly fragmented industry. Rail service companies (passenger rail franchises, freight operators) would negotiate access contracts with an infrastructure service provider (the track owner, initially envisaged as remaining in public ownership). Other industry services, such as the provision of rolling stock (engines, carriages and wagons (which would be provided by leasing companies)), or infrastructure maintenance, (provided by experienced units being sold to engineering firms), again using the contract mechanism to introduce “competitive tensions”.

Despite the elaborate structure, there was little in the way of real competition in the restructured industry, the only competition being between contractual parties in securing the best deal. And the resulting fragmented industry was so complex that it required two regulators to oversee (see diagram). The Office of Passenger Rail Franchising (OPRAF), the lesser of the two, would award franchises to companies competing to provide passenger rail services¹³ on the basis of least contribution from public funds (this was a means of continuing to recognize BR’s old PSOs while introducing competitive bidding as a means of reducing the size of grant necessary). The Office of the Rail Regulator (ORR) would grant a license to a new company that would own the network’s physical infrastructure (track, stations, signal boxes and so on) and oversee other facets of the new industry’s operations.

It is possible that vertical separation could have worked if the industry had not been splintered. An industry divided into just operating and infrastructure companies (possibly one that added separate provision of rolling stock as well) would have reduced the problem of increased information costs and the passing of blame. It would have also made the industry more resilient to regulatory incursions. Yet the setting up of so many companies created, as it were, an industry playing field in which there were so many disputes over the rules that the referees destroyed the flow of the game.

The New Rail Industry in 1996/97



Privatizing the infrastructure

Perhaps the most crucial decision taken in creating this new industry structure was to privatize the infrastructure company. While the economic rationale was clear — a major new company with a substantial asset portfolio could raise funds for infrastructure improvements against its own balance sheet — there was nevertheless a suspicion of political opportunism in the decision as at the time there was need for a substantial injection into public finances to pay for the then-unfolding “mad cow disease” fiasco of the mid-1990s which required government to compensate farmers for a massive cull of livestock.

The new company would be called Railtrack, to be sold on the stock market by an Initial Public Offering (IPO). The main question over its valuation related to the political risk to potential stock purchasers. The Labour party,

then in opposition but looking more and more as if it would form the next government, had announced its intention to take the railways back into public ownership. This uncertainty surely depressed the initial valuation placed on the company in 1996 by financial institutions. The government took their advice and sold the company at an initial offer price of £3.90 in May of that year; but the market soon discounted the political risk, theorizing that such a complex privatization would be too expensive for an incoming government, with many other expenditure priorities, to renationalize. Railtrack's stock price soared to £17.68 by the end of 1998, leading to charges that the privatization had significantly undervalued the company and to accusations of "windfall gains" to investors.

The new industry therefore consisted of over 30 separate companies, taking over a sector that had seen several years of continuous improvement, and bringing in a new wave of innovation. The public reacted by significantly increasing its use of the product. Peter Osborne summed up the industry's success in a piece for *The Spectator*:

The records show that the 1993 Railways Act was followed by a brief flowering of the railway industry. Passenger numbers — in decline since the Second World War — rose by about one third. There were more trains. Despite this added traffic there were fewer delays, and the safety record — measured, for instance, by the number of drivers going through red lights — sharply improved. In 1998, for the first time since 1902, there were no passenger deaths in a rail crash.¹⁴

If public purchase of a product is any measure of the product's success, then Railtrack's privatization must be regarded as an initial success on that ground alone. But on other grounds too, by 2000 the whole privatization had proved a success. A study by Cambridge University scholars Michael Pollitt and Andrew Smith in November 2001 found that:

[M]ajor efficiencies have been achieved, consumers have benefited through lower prices, whilst the increased government subsidy has been largely recouped through privatisation proceeds. We find that output quality has also improved [prior to the speed restrictions imposed after the Hatfield crash]. The achievement of further savings will be key to delivering improved rail services in the future...[A] privatised structure, where shareholders demand a return on their investment, has led to significant improvements in operating efficiency.¹⁵

Yet these improvements were not enough to stave off a crisis in the industry that has caused it to be the only British privatization that failed. The circumstances surrounding this crisis need to be explored in detail.

3. Accidents, political interference and financial collapse

Political opposition and new regulation

Peter Osborne's analysis of the privatized industry's startling success shows that it was nonetheless, "damned on every possible occasion by New Labour":

In 1998, even though on practically every measurement for safety and performance the industry was improving at a prodigious rate, John Prescott [Deputy to the new Prime Minister Tony Blair] labelled Railtrack a 'national disgrace'. He personally appointed a new regulator, a sharp, ambitious lawyer named Tom Winsor. Winsor issued a demand for 12.5 per cent better performance, on pain of the biggest ever fine in corporate history. He boasted: 'I'm not knocking Railtrack. I'm knocking it into shape.' In 1999 performance improved by 10 per cent, but Railtrack still copped a £10 million fine.¹⁶

This is indicative of the political problems the privatized industry faced. The market had been correct to assume renationalization unlikely. The Chancellor of the Exchequer for the Labour Government elected in 1997, Gordon Brown, had refused to commit the enormous sums necessary to buy back the network. But the market had been incorrect in reading this as justification for discounting political risk entirely. Regulation imposed new costs by adding new layers of political control on the industry.

As well as appointing a tough, interventionist regulator, the Labour government also added a further layer of regulation by creating a Strategic Rail Authority (SRA), which was intended to reintroduce a degree of central planning and coordination to the newly fragmented industry, despite privatization having already vested this responsibility in Railtrack as the company responsible for the infrastructure. In fact, the SRA's role and powers, especially in reference to ORR, were never made clear (see below for an explanation of how bad the situation got). The most significant responsibility of the SRA was its incorporation of the franchising powers and duties of OPRAF.

Yet despite the campaigns of regulation and vilification, it was, ironically in a safer railway, a succession of fatal accidents that caused the collapse of the privatized system. The rail system had seen an average level of 25–30 passenger deaths per billion kilometres travelled during the 70s and 80s, reaching a high of almost 40 in 1988. This record had improved immensely pre- and post- privatization, stabilizing at around 10 following the passage of the Railways Act 1993.

Accidents and further intervention

Then, in 1999, a crash at Ladbroke Grove killed 31 people. The next year, a crash at Hatfield (see Appendix 3) killed four, and led to the imposition of extensive speed restrictions as Railtrack checked the network for further track problems of the type that caused the crash. In both cases, the fragmented nature of the rail industry, caused by the convoluted method of privatization chosen,¹⁷ appeared to have contributed significantly to the accidents. A judicial inquiry headed by Lord Justice Cullen into the Ladbroke Grove crash, for instance, suggested that drivers (employed by the Train Operating Company) had not been warned about problems with the faulty signal (maintained by Railtrack) that led to the crash. At another crash, at Potters Bar, the Health and Safety Executive suggested that the loose bolts that caused the accident may have stemmed from communication problems both within Railtrack and between Railtrack and the infrastructure maintenance company.

The Hatfield crash revealed something many had suspected, but which had not adequately been taken account of in privatization. The infrastructure network had suffered from decades of under-investment during the years of public ownership. Yet whether the state of the assets could be described as dangerous, as public discussion of the problem implied, is debatable. Osborne comments:

Four people were killed at Hatfield, where [Railtrack] really was culpable. It has been pointed out since that traffic accidents claim that many people most days of the year. The reaction was disproportionate: trains were slowed close to walking pace as a hunt was made for rails in the same condition as the one that caused the Hatfield crash. None was ever found. Since Hatfield, running the company has been close to impossible, and the management has become paralysed by fear of being jailed on manslaughter charges as much as by lack of investment.¹⁸

Accidents led to another change in railway regulation. The Health and Safety Executive (HSE), which at the time of privatization had assumed responsibility for Her Majesty's Railway Inspectorate, began demanding more in the way of tests, rules and paperwork from the rail companies, especially Railtrack, in the name of safety. As Osborne says, this was a disproportionate reaction, akin to the HSE requiring certain checks on family cars following every fatal road accident. As we shall see below, even the Labour-dominated Transport Select Committee of the House of Commons was critical of the misplaced zeal of the HSE in the rail industry.

Collapse of investor confidence

The result of the increased regulatory pressure and the collapse of Railtrack's public image as a competent organization following the years of backbiting and the massive negative publicity surrounding the Hatfield crash was a steady decline in Railtrack's share price. From its high of over £17 in late 1998, the price had dropped to below the privatization value by late 2001. This significantly affected the company's ability to raise funds.

This was especially significant as Railtrack had responded to its difficulties by looking to expand investment in the network. According to its *Ten Year Plan* published in 2001, it would invest over £40 billion over the decade 2001–10, but £24 billion of that would come from private sources. Without the ability to raise the money from the private sector, Railtrack turned to the government via the regulator. Initially in April 2000, the government and regulator agreed to guarantee extra funding of £1.5 billion, but then in October 2001, as the *Financial Times* termed it, the government decided to “renege on the pledge.”

This pushed Railtrack over the edge. It was forced to go into liquidation and the Secretary of State for Transport, Stephen Byers, using a Railways Administration Order (envisaged in the Railways Act 1993 as enabling the state to ensure that the railways kept running in the event of a national emergency), took over Railtrack’s assets and created a new company to run them in its stead, refusing to pay the company’s shareholders a penny in compensation.¹⁹

The murky process by which this happened has become clearer with the release of new documents from ORR under the UK’s Freedom of Information Act. It is now apparent that Mr. Byers and the Labour government were unprepared to listen to the Regulator Tom Winsor’s attempts to broker any deal to keep Railtrack in business:

Mr Byers told the regulator Railtrack was in financial crisis and the only options were “three Rs” — renationalization, restructuring or receivership...

Mr Winsor's objections were rejected by Mr Byers, who said he “had the authority of the prime minister and the chancellor immediately to introduce emergency legislation to entitle the secretary of state to give instructions to the regulator.”

Mr Winsor said such a move would jeopardise the position of regulators in the gas, electricity, water and telecoms industries. He added it would have a “severe adverse effect” on confidence in the financial markets and could be illegal under the Human Rights Act.²⁰

While the market had been correct to dismiss the possibility of renationalization by the expected means of buying back the stock, it had failed to consider that a government would simply use the threat of legislation to override its own regulatory framework. The effect was a *de facto* renationalization of the infrastructure body. Yet the new industry that resulted, a mixture of privatized and government-owned bodies still generally described as a whole as “privatized,” was to be quite unlike any rail industry in world history.

4. The confused structure of the post-Railtrack industry

Contradictions within Network Rail

Network Rail, as the successor body to Railtrack was eventually named, is a highly unusual company. Its public line is that:

Network Rail is a company limited by guarantee. This means that, while we are a private organisation and operate as a commercial business, we have no shareholders. Instead we are accountable to members, who do not receive dividends or share capital. They have similar rights to those of shareholders in a public company, except they have no financial or economic interest in Network Rail. This means they have a duty to act in the best interests of the company without personal bias.²¹

In fact, Network Rail's members are a remarkable collection of 116 "stakeholders" in the industry, some of whose stake is barely discernable: they include the Crime Concern Trust, the Royal Association for Disability & Rehabilitation, trade unions, and the Cyclists' Touring Club. The company's corporate governance in such circumstances met with some scepticism from industry insiders:

Some rail industry chiefs are privately sceptical; pointing out that Network Rail's members will meet just a handful of times each year. One member said the body was "pointless," saying it was "more suitable for the management of a gentlemen's luncheon club than a railway."²²

It is this body that has been charged with the running of Britain's rail infrastructure, much to the bemusement of the City of London and other financiers, and even to the Rail Regulator. The main point of the structure seems to be to avoid the charges of corporate greed levelled at Railtrack, but in so doing the structure lacks any incentives for good management. George Trefgarne of the *Daily Telegraph* commented:

The members' role has a contradiction at the heart of it. We are told they have, "similar rights to those of shareholders in a public company," yet "no financial or economic interest" in whether Network works.

But the whole point of shareholders is they have a financial and economic interest. In return for making their investment and scrutinising the company's affairs, they are entitled to

dividends paid out of any profit. This encourages them to exercise their rights and duties diligently.

Network Rail is a sort of Third Way on wheels. Tom Winsor, the rail regulator, believes it is a nonsense. He says a company with no shareholders is hard to incentivise. If he fined Railtrack for poor performance, it came out of shareholders' pockets.

But Network Rail has no shareholders, so just passes a fine on to the taxpayer or passengers in higher costs. "Shareholders with money at stake," said Winsor, "are far more likely to be responsive than public interest members."²³

Network Rail has indeed proved to be a poor steward of the company's assets. By all accounts, its management consists of little more than asking the Rail Regulator for more and more money while raising finance from the private sector on the understanding that the government backs its debts. Its current plan envisages spending £26 billion over the next five years. As the government has guaranteed this money, it is essentially a form of state aid that dwarfs all other such subsidies paid in the UK, and in the rest of Europe for that matter. The guarantee amounts to state aid of €37.5 billion, while the rest of Britain's state aid amounts to €3.7 billion in total (Germany spends €13 in state aid, the most in Europe).

Network Rail has still failed to match the performance levels set by Railtrack before the Hatfield crash. Currently only 76 percent of trains run punctually to timetable, a figure far below Railtrack's pre-Hatfield levels of 90 percent (and below even the 85 percent level achieved by Railtrack in early 2001, once the initial post-Hatfield delays had passed).

Regulatory confusions

Moreover, it is not only Network Rail's internal governance that appears confusing. The regulatory framework is now hopelessly muddled. In evidence to the Transport Select Committee, Dr Dieter Helm, an economist at New College, Oxford, explained the confused relationship between government, regulator, Network Rail and SRA as they currently stand:

The Department for Transport's role is subsidiary to that of the Treasury and spending review, leaving the status of the Ten Year Plan ambiguous;

the SRA's role depends on the Department for Transport's priorities, and the guidance provided to it;

the SRA's budget is notionally outside the main government borrowing calculations, but in reality is determined by the Treasury;

the Rail Regulator decides the track access charges which, in practice, are paid by the SRA at the margin;

thus, the Rail Regulator determined how much money the SRA pays Network Rail and the TOCs and therefore how much money the Treasury pays the SRA via the Department for Transport;

the outputs are, however, determined by the SRA, which effectively carries out the capital planning function (which Railtrack previously did);

Network Rail therefore is largely responsible for the operations of the railways, and the SRA for its capital development, confusing the roles of management and responsibility;

the Rail Regulator and the SRA have a concordat which cements this confusion of roles between them.

As a result, it is not surprising that there are often sharp differences of opinion between all the main parties: the Treasury, the Department for Transport, the SRA, the ORR and Network Rail. Tom Winsor, Rail Regulator, sees himself as the 'referee', but one who has to take into account the aims of the SRA, and whose decisions ultimately determine public expenditure on the railways."²⁴

The committee added in its report that, "This picture does not represent the extent of the confusion, and lack of coordination between the main bodies, which we found."

For example, the committee found:

[A]n astonishing and fundamental disagreement between the Government and the Regulator about the extent of the latter's powers. According to the Minister, the Government had a choice about whether to accept the Regulator's access charges settlement; but the Regulator considered that the Government had no option but to accept his decision. This is a prime example of the confusion which lies at the heart of the present structure of the railway and why it is essential that this structure must be streamlined."²⁵

Faced with this regulatory confusion, and because of the way in which government funding now swamps private sector involvement, the "privatized" industry has ceased to be privatized in all except name. The private sector companies assume little funding risk because of the government's guarantee and their attempts at innovation are lost in the regulatory swamp. As a result, costs are soaring. The Transport Select Committee commented, in a section of its 2004 report entitled, "The Government's Failure":

It is vital that the recent surge in costs for the railway is checked. The Government has told us that it is in control of the industry. But the swelling subsidy figures of recent years tell the real story of an industry that is out of effective control...Relying on incremental improvements may take many years to produce results; ill judged restructuring will damage the industry further. However the Government chooses to reverse the present position of the railway, it will be essential that in future it ensures proper control over the money it provides. The Government must ensure that the private sector assumes real risk where it is involved in providing railway services in future.²⁶

Faced with a situation in which private sector disciplines and expertise cannot be brought to bear because of a malfunctioning regulatory system, it is safe to say that, with the industry as currently constituted, rail privatization in the UK has failed.

5. Analysis — what went wrong?

Privatization — or politics?

Most commentators agree about what went wrong with Britain's rail industry: privatization, and privatization alone, wrecked Britain's railways, in the words of transportation journalist Christian Wolmar.²⁷ Yet when asked to explain further, most commentators immediately point to the real causes: the fragmentation of the industry and the disastrous over-regulation that accompanied it.

The problem with blaming privatization is that it relies primarily on a caricature of the private sector as rapacious and concerned only with the fast buck, the short-term and the bottom line. But in fact, capitalism actually encourages long-term thinking because its institutions ascribe value based on future prospects. Stock market valuation, for instance, takes into account all actions that will affect future profitability and sustainability. A company that is focused only on the immediate bottom line to the exclusion of future considerations will find its value discounted heavily. This should be contrasted with the short-term time horizon of politicians and the political funding cycle: In the UK, the Public Expenditure Survey looks only three years ahead. Short-termism by politicians, not the private sector, caused the successive funding crises of BR and the infrastructure degradation that led ultimately to Railtrack's demise.

Much was also made of Railtrack's early success and the "windfall" gains made by shareholders while the executives pocketed fat bonuses. As explained earlier, the windfall gains were caused by the initial failure of the government to value Railtrack properly when it was privatized. A more realistic sales price would have reduced these windfall gains. The issue of executive compensation, meanwhile, is irrelevant to the rail industry's situation. The character of executive compensation is currently such that bonuses of this kind are standard among senior management. There may or may not be a problem with how executives are compensated, but to expect the British rail industry to have come up with the answer to any such problem is unreasonable when it affects large enterprises globally.²⁸

Cost-cutting — or fragmentation?

The most potent argument advanced in favour of privatization wrecking the railways in fact points in another direction. It is argued that the new private sector managers did not understand the railways, and the fragmentation of the railways led to the loss of valuable experience that caused the communication problems that led to Railtrack's demise. There is a degree of truth in this, as Railtrack certainly lost necessary experience that could have averted financial and operational problems. Old railway hands with years of experience were sacked or replaced with inexperienced staff when they so

easily could have remained. Yet this may well have happened even if Railtrack had remained in the public sector. The problem was not so much the new ownership as the new organizational structure of the industry. When an organization is split up, as British Rail was, there is a conflict between duplication and efficiency. While it can be reassuring to have some functions duplicated in many places, it can also be inefficient. Must every part of the newly split sector employ people responsible for the same issue?

Efficiency may have suggested that Railtrack had no need to reproduce the engineering experience that were now in place in different parts of the split infrastructure sector. But ultimately it derailed the business.

Yet the same might well have happened to a public-sector infrastructure company that was working within a fragmented rail industry. It would also want to minimize unnecessary duplication so as to maximize value for the taxpayer. While Railtrack failed to strike the right balance, a state-run company would have been just as likely to fail in such circumstances.²⁹

Fragmentation confusion, and cost

It was fragmentation, not the fact of privatization itself, that imposed large communication costs on the industry, to which were added further costs in the form of an overbearing regulatory system, such that the fragmented industry found itself squeezed.

Within just a few years, the rail industry went from having one major and one minor regulator to in effect having three separate, powerful regulators and one publicly-owned company. The Transport Select Committee heard evidence that confirmed that the responsibilities of these bodies conflicted and in some case contradicted each other, confusing the industry and thereby raising information costs still further. The committee found that:

We have seen no evidence, since our predecessors reported two years ago, that fragmentation in the rail industry has reduced. Indeed, our evidence has suggested that it is getting worse. In addition, industry costs are increasing; performance remains in the doldrums; and the SRA appears utterly incapable of managing significant improvements. The evidence of the Rail Regulator's Interim Review of track access charges is that the Regulator and the SRA are not co-operating well...³⁰

It became clear that, as the railway system is currently governed, there is no one organisation capable of properly addressing the [industry's problems]. In our view, until there is a single body with the authority to deal with these questions, government and the rail industry are condemned to spending energy debating structural issues rather than getting on and running the railway for the benefit of the travelling public and the country.³¹

While the committee's suggestion of a single regulatory body as the solution is entirely debatable, its analysis that the various parties are condemned to endless quibbling is sound.

Moreover, the committee (in unusually strong language) pointed out that two of the public bodies responsible for the railway had failed to live up to their mission:

[The Government created] another fudge by creating Network Rail, a private company without any private sector disciplines, seemingly set up simply to keep the enormous costs of the railway infrastructure away from the Government's balance sheet. In addition, we have found that the Health and Safety Executive is regulating railway safety without full regard for the improving safety record of the industry or its ability to fund improvements. The result is that spending in this area is a major contribution to soaring costs but with progressively less safety gain.³²

The other two public bodies, ORR and the SRA, had also failed in their mission, much to the Committee's distaste:

Economic regulation of the railway, as presently organised, has largely failed. However, if the private sector continues to be involved, there will be a role in future for a measure of independent economic regulation to 'hold the ring' between the infrastructure provider and the private sector companies.³³

Regulatory failure, not market failure

The committee, while believing in government control, recognized that when political decisions override regulatory and business decisions, there is no real regulated market to speak of. The regulator had become a permanent funding mechanism, rather than a temporary agent to help the market find its feet, as envisaged at privatization.

Public dominance over the privatized railway is actually a clear case, not of *market failure*, but of *government and regulatory failure*.

What next?

So what is the solution to this wholly unsatisfactory situation? The Transport Select Committee, noticeably failing to learn from the lessons of the past, suggested the introduction of a Railway Agency to replace the various regulators and Network Rail. Its suggested powers and function are described as follows:

This new executive body would combine the strategy and output delivery functions of the SRA with control of the

infrastructure, and must be given all the powers required to manage the entire rail system and to deliver excellent services for the travelling public. Combining these functions will permit the body responsible for growth and targets also to manage the means of achieving improvements, and to receive funding at the cheapest level. However, this body must demonstrate a much greater creativity and vigour than its predecessors if these new arrangements are to have a chance of working. The travelling public do not care who runs railway services; their concern, quite properly, is with efficiency and value for money. While the private sector may therefore continue to provide some train and infrastructure services, where that clearly provides the best option, the Government needs to keep an open mind on the provision of these services directly by the public sector.³⁴

This clearly goes well beyond the previous solutions of regulation or even of nationalized industries in imposing direct government control over the railways. When the National Health Service (NHS) took over Britain's health care in 1948, its creator, Aneurin Bevan, said that he "wanted the clang of every dropped bedpan to reverberate around Whitehall and Westminster." The NHS has been a disaster in terms of lack of investment and inefficiency, two entirely predictable outcomes from such centralized planning. To turn the railways into an "NHS on wheels" is an alarming prospect.

It appears that even the government has decided that too many regulators spoil the broth. On April 7, 2005, the Railways Act 2005 received Royal Assent. This abolished the SRA and transfers its responsibilities to the Secretary of State for Transport (in some cases to devolved regional administrations), while establishing the Office of Rail Regulation (an ORR version 2.0) to be a combined economic and safety regulator (the duties of HSE will transfer to ORR).³⁵ While certainly a better solution than that proposed by the Transport Select Committee, the provisions of the new Railways Act suffer from the same problem of instituting political control. The problem of government failure with respect to the railways will therefore continue just as it has since the First World War.

Problem-solving approaches

Instead, a sensible approach to the problems of the rail industry would look at what have proved the major problems and attempt to solve them. As identified above, the major problems have been the coercive fragmentation of the industry and over-zealous regulation.

A degree of fragmentation may indeed be necessary in the rail market to ensure some form of competition.³⁶ However, vertical separation of the industry has proved to increase information costs to a level where the industry suffers badly as a result. An efficient rail industry needs to be vertically integrated, and so needs to be restructured once more.

There are two possible approaches. One is to return to the regional companies model originally considered for the privatized industry. This would, however, require something approaching renationalization of the entire industry in order to bring it about.

Instead, we might profitably consider a suggestion made by the former Conservative Environment Secretary John Redwood MP in an article in *The Times*. Alongside advocating the abolition of the SRA, Redwood notes that:

[Transport Secretary Alistair] Darling is tiptoeing towards the train company solution – reunite trains and track. He is trying out joint offices, where problems can be resolved more quickly, blame apportioned and remedies applied all in one go through joint working. This is a sensible measure. He is looking at whether new ways of collaborative working can be tried on the least used path.³⁷

Redwood suggests that the logical conclusion is to allow train operating companies to purchase Network Rail assets, which he notes would reduce the inefficiencies caused by separation, would allow operations to drive investment and make the private sector more likely to fund more services.

Redwood's solution would, in other words, reduce information costs, while allowing the private sector to apply its disciplines to solve the problems of investment and funding. While it is probable that many of the newly reintegrated lines might prove to be too small to operate independently, it is likely that there would then prove to be a period of consolidation as the existing train companies merged to produce economically efficient companies that might then be able to cross-subsidize and become less dependent on government funding.

There are some who argue that the process of investing in new rail infrastructure is so expensive that it can only be done with government subsidy. In part this reflects the nature of the approvals process for new transport works in the UK (qv). Admirably designed to protect individual property rights, the process is therefore extremely burdensome to the promoter, and it may be appropriate for the government to bear rather more of the legislative risk associated with the procedure as just compensation. If, however, the demands for subsidy are to do with costs beyond the approvals process, then it needs to be asked whether the transport need for the new infrastructure it is designed to meet is best met by rail. In some cases, road development will be a better and a better use of government funds. In cases where rail is a better solution, then direct subsidy may still not be the answer. Other incentives, such as tax breaks or even levelling the playing field with other forms of transport (for instance, appropriate use of road charging to counteract the *de facto* subsidy given to road users) may help make the business case more attractive to private finance. Government subsidy for infrastructure development should be a last resort rather than a first port of call.

Empowering the market

Indeed, the ultimate target of such a programme must, once again, be the elimination of government funding. Experience has shown that demand for government funding where it exists grows because it is a steady income stream — this is the economic phenomenon of “rent-seeking.” Yet with government funding comes naturally the desire for more government control and regulation, with all the attendant problems we have examined.

The greatest benefit of such an approach, however, would be to allow the private sector to apply the “ultimate resource” of human ingenuity to the problems besetting the industry, something the public sector has proved far less able to do. As John Redwood says:

The railway is very old technology, struggling to adapt to the weight, speed and volume demands of the modern world. While China puts in a Maglev system capable of running at more than twice the speed of anything we have, and as Japan’s privatized railway shows what can be achieved with more modern, dedicated track for true express trains, the UK patches and muddles on a Victorian railway, improving the way they tip sand on the track in their desperate search for grip when braking.

The best hope for the railways would be to give or sell control of the track to private companies running the trains, to limit the amount of subsidy they will be granted, and to encourage new technology developments for the new routes public transport ought to have.

Investment has to be made in the private sector — neither main party will be able to spend enough to solve the problem on the public account. Pretending that Network Rail, a state pensioner, is a private sector risk-bearing company is not the answer.³⁸

This is the obvious answer to the Transport Select Committee’s call for “much greater creativity and vigour” in the rail industry. These are areas in which the private sector consistently demonstrates its superiority over the public sector.

Experience both in the UK and the US has shown that using regulation to force a degree of vertical separation on an industry that works best when integrated is extremely counterproductive, to the extent that it might force market failure. The biggest potential obstacle to the reintegration of the UK rail industry is European Directive EC 91/440 (see Appendix 2) and its successors. Reintegration might be objectionable under European Union law and might therefore have more significant reverberations, given the current nature of the debate over Britain’s role in Europe.³⁹ Nevertheless, from a transportation standpoint, the answer seems clear. Britain’s railways must be reintegrated and freed from their regulatory straitjacket if they are to play a useful role in meeting Britain’s transportation needs in the foreseeable future.

Taking the railways back into public ownership without adjusting the structure or any other variant of blaming privatization would represent merely a distraction from this important truth.

Privatization could have been the answer to Britain's rail problems, but the job can only be completed by restructuring and genuine deregulation. There is, interestingly, a model for successful rail deregulation — the American model.

6. Lessons from rail deregulation in the United States

Different problems, same interventionist zeal

The American railroad system grew at the same explosive rate as the British, yet evolved differently. While the British railways became predominantly oriented toward passenger travel after the rise of cheap competition in the form of lorries, freight transportation remained the focus of the American system. This difference led to a parallel difference in the focus of regulation. Safety issues initially led to government regulation in the UK. In the US, commercial considerations dominated, as government responded to accusations that the rates charged by railroads were high and discriminatory.

In response, Congress created the Interstate Commerce Commission (ICC) in 1887, which had the authority to regulate the rates railroads could charge carriers. The ICC soon found that there was no objective way it could do so, and instead consistently caved in to pressure from freight carriers for lower rates, which in turn led to a lack of investment in the infrastructure.

The ICC also began to regulate in areas beyond rates: regulation of routes, equipment acquisition and utilization, labour practices, service offerings, consumer relations, and just about every other aspect of railroad operations. Private sector choice and innovation were suppressed. When, for instance, Southern Railway proposed to introduce 100-ton hopper wagons in the 1960s that would lower rates for its shippers, the ICC decided that this was simply a way to give some of its customers discriminatory rate reductions and prohibited their use, until the Supreme Court intervened.

After almost a century of such overweening regulation, the industry was on the point of collapse. As Peter Ferrara summarizes:

By the end of the 1970s, the railroad industry was fading into complete disarray. While railroad rates ended up climbing 2 percentage points faster than inflation each year over the previous decade, the industry's annual return on investment had fallen to less than 2%. The government had taken over most of the major North-eastern railroads, which had collapsed into bankruptcy. Nationally, railroads accounting for over 20% of the nation's track were bankrupt.

Because railroads were no longer able to finance capital investment, their track and equipment deteriorated. By the mid-1970s, deferred maintenance and delayed capital expenditures amounted to billions of dollars. The rate of accidents due to track or structure defects quadrupled from 1966 to 1976. Because of such safety problems, almost 50,000

miles of track, about 15% of all track nationally, could be operated only at reduced speeds, as slow as 10 miles per hour. The new phenomenon of “standing derailments” arose, which meant that some tracks were so deteriorated that train cars derailed while standing perfectly still.⁴⁰

This should sound familiar. Over-mighty regulation of a supposedly private sector industry led to an investment backlog, increased accidents, reduced punctuality and the bankruptcy of companies. Despite the dissimilarities in the nature of their business, the effects of regulation on British and American railroads were the same.

Unfettering the private sector

The US Congress,⁴¹ like the UK Parliament, recognized the problems, but their solutions are different. Congress, rather than proposing nationalization, passed the Staggers Rail Act in 1980, repealing most of the ICC’s powers except the authority to regulate in cases of market abuse. Contracts between rail companies and shippers were exempted from regulation, allowing prices to be set by the market, rather than by regulators. The railroads were also allowed to determine their own routes, which meant the abandonment of routes that were found to be uneconomic, although interestingly many of these routes were bought by new companies that sprang up following deregulation.⁴²

With their fetters cut, the private sector companies were able to make much greater returns and in turn invest those returns in maintenance and new infrastructure. Over \$120 billion was invested in the 1990s, with \$15 billion in new track and rolling stock during 1997 alone.⁴³ These are levels of investment that the British rail industry would dream of. Yet the investment has not been at the expense of shippers. In fact, rail rates have fallen by 55 percent on average from their regulated levels.

Economists Barnekov and Kleit summarized in 1990:

A rough calculation of annual total welfare gains in the United States from rail deregulation resulting from the Staggers Act would include something on the order of \$5.3 billion to \$7.2 billion in lower rates to shippers, \$5 billion to \$10 billion in reduced inventory-related logistics costs, slightly less than \$500 million in higher profits to railroads, and slightly over \$700 million in savings to taxpayers.⁴⁴

These are exactly the sorts of benefits that rail privatization was supposed to secure for British taxpayers and was on the road to securing before the forced collapse of Railtrack. (It should be noted that deregulation of the British bus industry in 1986 led by 1999 to a 40 percent decrease in total costs and a 27 percent increase in service miles.)

No vertical separation

It is worth noting here that the 1980 deregulation model was somewhat different to other deregulations in the US. Most network industry “deregulations” in the US have involved vertical separations, like rail in the UK, into the “grids” that provide the infrastructure (such as the rail track or the electric supply grid) and the “flows” that travel along the grids (such as train services or the electricity supply itself). In most of these cases, business surrounding the flows has been deregulated, while the grids themselves remain highly regulated. The regulatory bodies, meanwhile, like the rail regulators in the UK or the pre-1980 ICC, have been willing to take any accident or public concern as an opportunity to extend their powers. Thus, when electricity blackouts shut down much of the Northeast for a day in the summer of 2003, regulators were quick to announce plans to more tightly control the electricity supply grid.

Rail deregulation, however, avoided such pitfalls, partly because there was no vertical separation of the industry when regulation began in 1887. The deregulated rail industry was free to fix service contracts at levels that met the needs of all parties, rather than subjugating the needs of the grid to the demands of the flows. Sadly, this has been the case with other network industries in the US, and remains the case in the UK, where even artificial demand (the requirements of politics voiced through regulators) dictates how the industry will approach supply.

Lessons for each country

Each of the two countries’ experiences with public-sector involvement in the rail industry provides lessons for the other in both rail and in network industries in general.

From the US experience, the following lessons apply:

- Light regulation that targets neither grids nor flows allows the private sector most latitude to bring its skills to bear.
- Freedom to fix contracts at mutually beneficial levels is good for the industry.
- Removing regulation can lower costs and raise capital investment to substantial levels if the industry is free to choose its own routes.

From the UK experience, we learn the following:

- Privatization is meaningless if the industry is not free to use private sector solutions.
- Enforced separation of infrastructure and operations increases information costs to a level that may affect the viability of the industry (as well as introduce potentially distorting regulatory costs if one aspect is regulated more than the other).
- Political risk can reach crippling levels if the industry is not protected from arbitrary government decisions.

And from both we learn that:

- Over-mighty regulators degrade the industry as much as public ownership. In general, the less government involvement the better.
- Investment in rail infrastructure and equipment cannot be short-changed without eventual significant damage to every party involved; regulations, laws or ownership structures that lead to underinvestment or disinvestment are bound to be harmful.
- Private investors will not put capital in unless they are assured of an opportunity to make money on their investments.
- Regulatory stability is important for investor confidence.
- The complexities of rail operations require smooth information flows. Vertical integration helps achieve this.

Indeed, it could be said that the way privatization evolved in the UK simply put the British rail industry in a bind similar to that of the pre-Staggers American rail industry.

The irrepressible urge to regulate

Nevertheless, the calls to re-regulate the American rail industry abound. Some rail shippers oppose deregulation because their access charges have risen, and are calling for an open access requirement that would require regulators to set rates once more. But this would simply reduce the benefits to the industry of the free and fair competition, introduced by Staggers, and reduce the funds available to railroads for capital investment. It would also reintroduce a system of market-distorting federal subsidies. There is ample evidence, as we have seen, from both sides of the Atlantic that these “solutions” do nothing more than damage the industry — at great cost to the taxpayer.

As Dr Jerry Hausman wrote when re-regulation was proposed during the 107th Congress:

The current proposals for new regulations would inevitably lead to lower prices and lower returns on investment for the railroads, and ultimately poorer service. Since there is widespread agreement that railroads are not currently earning their cost of capital, lower prices and lower returns on investment would decrease the economic incentive for further investment. Thus, the ability of the railroads to attract capital and reinvest in plants and improve levels of service would decrease. Indeed, the ability and incentive to maintain present levels of service to existing shippers may be placed in jeopardy because the economic benefits of replacement investment and investment to accommodate expected growth may not be forthcoming, given the low levels of expected returns.

Railroads will need significant replacement investment as well as new investment to serve expected growth. The

railroads entered the period of deregulation with significant excess capacity. Growth over the past 20 years of over 50 percent in volume, as well as the rationalization of the railroad networks, has eliminated much of the excess capacity from the networks. Replacement investment is necessary to satisfy future growth. But the contemplated new regulations would lower rates and decrease the railroads' return on any new investments.⁴⁵

Such arguments apply equally to the British railways. British rail privatization should have provided the nation with benefits similar to those enjoyed by the United States following deregulation: by allowing the invisible hand of the market to take charge. Instead, a complex and confused regulatory framework placed an invisible foot on the industry's throat, choking off the lifeblood of private sector innovation. It should come as no surprise that significant resuscitation efforts are now required.

Appendix 1: Project approval and political risk: CrossRail and Central Railways

London's workforce is dependent on rail. As it was inherited from previous, smaller populations, the city's road system is simply inadequate for the purpose of the daily commute. This structural problem has been exacerbated by the environmental pressures that led to the introduction of the congestion charge, which dramatically reduced the number of cars entering central London.

The periods of economic growth in the 1980s and '90s have therefore placed increasing strain on London's rail system — both the London Underground system and the more conventional overground network. Recognizing the problem, the Thatcher government instituted the Central London Rail Study to examine potential solutions to the problem. One of the study's recommendations was that a new rail line be built serving a similar function to the RER in Paris, a regional rail express route that combined the functions of long-distance train and regional metro. The new line, called CrossRail, would consist of a new tunnel under Central London linking up services that presently fed into terminals and allowing them to serve Central London destinations directly. The service would significantly relieve pressure on the underground, improve journey times, and reduce traffic congestion by attracting passengers off the roads.

Yet the construction of such a line would be both costly and disruptive. This opened the project up to two forms of political risk. The high and rising cost estimates meant that the Treasury became increasingly unwilling to fund construction as a traditional public sector project. The disruption meant that the Parliamentary approval process would attract considerable opposition. Indeed, this opposition led to the Parliamentary Committee finding the case for the project not proven.

These forms of political risk fed off each other. Private-sector investment was unlikely to be forthcoming until the powers to secure the project had been secured, while Parliament was unlikely to grant powers to a project that had not yet secured the funding necessary to build it. Experience had shown that the existence of powers for lines that were not built had created extensive blight on the values of properties near the lines, for instance.

This is exactly the problem that has beset Central Railways Group, a consortium founded to rebuild an old railway (closed in the Beeching cuts) to act as a freight railway linking the Midlands to the Channel Tunnel. The consortium has never been able to attract enough investment to satisfy government that the line has a realistic chance of being built, but explains that its funding is dependent on it gaining approval for the project. Significant privately-motivated expansion of the rail network is therefore unlikely while the approval process remains politically managed.

A new, politically-sanctioned version of CrossRail is currently beginning its approval process all over again.

Appendix 2: The European dimension: European Directive EC 91/440

Article 6 of European Directive EC 91 / 440 (first promulgated in 1991) was adopted following the seeming success of vertical separation of rail infrastructure and operations in Sweden. It states:

Separation between infrastructure management and transport operations

1. Member States shall take the measures necessary to ensure that separate profit and loss accounts and balance sheets are kept and published, on the one hand, for business relating to the provision of transport services by railway undertakings and, on the other, for business relating to the management of railway infrastructure. Public funds paid to one of these two areas of activity may not be transferred to the other. The accounts for the two areas of activity shall be kept in a way that reflects this prohibition.

2. Member States may also provide that this separation shall require the organisation of distinct divisions within a single undertaking or that the infrastructure shall be managed by a separate entity.

As Community law, this has been adopted by all European Union countries, but with differing methods of application. The UK and the Netherlands, for instance, took advantage of section 2 and created separate entities to manage infrastructure and operations (the Netherlands even separated out timetabling and signalling from infrastructure). In France, on the other hand, the infrastructure operator RFF contracts out all work to operations manager SNCF.

The differing experiences are instructive. Swiss transport analyst Carlo Pfund reviewed them for Swiss rail think-tank LITRA and discovered that, for instance, fragmentation in the Netherlands had been as much a problem as in the UK, without the saving grace of improved customer service and new trains. In fact, the Dutch experience became known as, “Crisis and Collapse” and led to the sacking of the head of the train operating company, NS, by the Department of Transport.⁴⁶

Even in France communication problems increased with separation. Pfund reports that network planning suffered after the beginning of a “turf war” between RFF and SNCF.

Separation did not inevitably lead to problems, however, with the Swedish system avoiding most of the problems elsewhere. Norway and Finland similarly coped with the change. Pfund concludes that the severest problems were felt on the densest networks, like the UK and Netherlands. As British transport expert Patrick Crozier sums up, “It seems that dense networks with high-intensity operations magnify the problems of fragmentation.”

EC 91 / 440 remains in place, however. It continues to be a significant obstacle to any plans to reunite infrastructure and operations under the same ownership.

Appendix 3: The Hatfield derailment and its consequences

On October 17, 2000, a rail accident at Hatfield killed four people. It also led directly to the death of Railtrack. Christian Wolmar summarizes the trivial incidents that led up to the crash:

In March 2000 when wagons carrying new rails to replace a cracked section of track arrived at the site near Hatfield, the workers on the line found they could not unload them because it was the wrong type of train. They would have had to turn off the overhead line electrification, a process that would have taken too long and caused a delay to the reopening of the line. So the new rails went back to the depot and the cracked rail remained in place, with dozens of trains thundering over the faulty section at 115mph every day. Three more attempts to deliver the rails were made and, when they did eventually arrive, it was too late, because the busy summer timetable did not allow for the lengthy line closure such a major job require. So, for a further six months the line was left unrepaired until, on 17 October, it gave up the ghost. As the 12.10 London to Leeds train passed over the damaged section of track, the rail shattered into 300 pieces, causing seven of the nine coaches to jump off the tracks. Most seriously, the buffet car smashed into a stanchion holding the overhead wiring and four of its occupants were killed.

The series of errors was summed up by Chris Garnett, chief executive of train operating company GNER who told Wolmar, "The accident at Hatfield was not caused by a broken rail. It was caused by total mismanagement by Railtrack and its contractors." It appears that, because of the separation of tasks between Railtrack and its contractor, no-one was actually responsible for ensuring the broken rail's replacement. Yet, as Wolmar goes on to note, "Hatfield would have remained no more than a footnote in British railway history had it not been for the subsequent imposition of thousands of speed restrictions that caused chaos for rail travellers and hundreds of millions of pounds in compensation claims by the train operators."

Railtrack simply panicked in its reaction to the crash, and it seems that the lack of detailed knowledge of engineering and railway operations in Railtrack's senior management was the problem. By the time of Hatfield, Railtrack had only two engineers on its board, and one of those was responsible for liaison with the train operating companies. Railway operations were under the direction of Jonson Cox, a man with no railway management experience who had joined the company from the water industry.⁴⁷ He had to take the decision about whether to impose speed restrictions. With no experience to guide his decision, he took a precautionary approach which, it turned out, had a fatal impact on Railtrack's finances.

The lack of experience was crucial in the decision because Cox was given conflicting advice by his juniors. Railtrack's head of track, David Ventry, recommended that speed restrictions should be placed on all sections of track where there was evidence of, "gauge corner cracking" and that those restrictions should be at 20mph, the maximum speed at which a train can remain upright when derailed. It was the extreme precautionary approach. Andrew McNaughton, head of the Great Western zone, brought in specifically to help deal with the crisis, argued that the restriction should be at two-thirds of the maximum line speed because at that speed the weight of the train is balanced equally on the two rails. Cox's decision to follow Ventry's

advice — without knowing how many sites would be affected — led to instructions that brought the railways almost to a halt. Indeed, the West Coast Main Line was initially closed because one zone director concluded that train operations were impossible. Experienced railway hands regarded Railtrack's approach as far too cautious, with Sir Alistair Morton, chairman of the SRA, calling it an "overreaction" and evidence of a "nervous breakdown" of the railways.

Yet the fault was not Railtrack's alone. It was exacerbated by regulators. Lifting speed restrictions required the consent of Her Majesty's Railway Inspectorate (HMRI), part of the HSE. HMRI ruled that lifting speed restrictions would require a risk assessment of the site (by May 2001, 1286 sites had been affected). It also instructed Railtrack to prepare of detailed guidance on the criteria used to impose and remove the restrictions, which the company was slow to do.

There was some bad luck as well. Bad weather caused the worst flooding in years, closing the East Coast Main Line north of York, and many other lines in remote areas around the country. This compounded the journey time delays that speed restrictions had caused — in many places journey times doubled and some day trips became impossible. As Wolmar put it, "Public transport was, in effect, suspended, a poor advertisement for the rail industry's wares which was to have a long-term effect."

The direct cost of Hatfield and its restrictions turned out to be £733 million, but the cost to Railtrack's value was much greater, with its share price beginning a precipitous journey downhill. The Chief Executive, Gerald Corbett (who had offered his resignation to the board on the day of the accident, only to have it turned down), and Cox were both sacked. Many of Cox's responsibilities were given to Corbett's successor, Steve Marshall, another industry outsider who had joined the company from Grand Metropolitan. Richard Middleton, the engineer serving as commercial director mentioned above, was made technical director, but was initially expected to report to Cox before his sacking, which led to Middleton threatening to resign. McNaughton was made chief engineer, although he was not given board status. Even after Hatfield, only two of Railtrack's seven board members possessed substantial railway experience.

Notes

¹ Published by the Institute of Economic Affairs (IEA), London, July 2003. See <http://www.iaa.org.uk/record.jsp?type=publication&ID=210>

² *"Broken Rails: How Privatisation Wrecked Britain's Railways,"* Aurum Press, London, November 2001, p.27

³ *Ibid.*, p.29

⁴ An attitude soon lampooned in popular culture, such as the long-running BBC series *The Men from the Ministry* (1962).

⁵ The BTC was swiftly abolished after Beeching's appointment, and he became Chairman of BR.

⁶ As it happened, Marples was replaced as Transport Minister following his party's defeat in the 1964 election, which slowed down the closure problem, but new Minister Tom Fraser still authorized 1,071 miles of closure in 1965.

⁷ Quoted in Wolmar, *op.cit.*

⁸ *Ibid.*, p.56

⁹ *Ibid.*, p.52

¹⁰ *Ibid.*, p.55

¹¹ It is believed that this was the preferred option of Prime Minister John Major.

¹² *"The Right Lines,"* Kenneth Irvine, Adam Smith Institute, London, 1987

¹³ Selling tickets and operating services using leased rolling stock, running over the infrastructure provider's track.

¹⁴ Oct. 18, 2001

¹⁵ DAE Working Paper 0118, available at <http://www.econ.cam.ac.uk/dae/repec/cam/pdf/WP0118.pdf>

¹⁶ Peter Osborne, *The Spectator*, Oct. 18, 2001

¹⁷ This can be seen in other industries. A misplaced fear of private monopoly creates unreliable power grids, as demonstrated by the US blackouts of 2003, which were at least partly attributable to Depression-era laws that keep the industry fragmented.

¹⁸ Peter Osborne, *The Spectator*, Oct. 18, 2001

¹⁹ The legality of the Secretary of State's actions is questionable. As Osborne put it, "First, those who bought shares after last April's announcement of government backing were misled. There is no doubt of that. Second, there is every chance that Stephen Byers has contravened Section 4 of the Railways Act and its demand that the regulator should make sure it is not 'unduly difficult' for Railtrack to finance itself: in other words, it was the government that made the company bankrupt. Thirdly, the shareholders are looking into the likelihood that there was a false market in the shares once the decision to act had been taken." In March 2002, the government finally offered compensation of £2.50 per share, which valued the company at about £500 million. Legal action on behalf of the shareholders is still ongoing, as a large group contends that in October 2001 Mr. Byers publicly rejected renationalization by purchase as an option on the ground that Railtrack's value was £7-£8 million including its debts.

²⁰ "Railtrack's fate sealed with Byers' threat," Andrew Clark, transport correspondent, *The Guardian*, Thursday March 31, 2005.

²¹ <http://www.networkrail.co.uk/companyinformation/index.htm>

²² "Think tank lays into Network Rail structure," by Andrew Clark, transport correspondent, *The Guardian*, September 16, 2002

²³ "The market knows how to run a railway," June 9 2003

²⁴ House of Commons Transport Select Committee, Seventh Report 2003-4, *"The Future of the Railways"* (p.7). Available at <http://www.parliament.the-stationery-office.co.uk/pa/cm200304/cmselect/cmtran/145/14502.htm>

²⁵ *Ibid.*, p. 19

²⁶ *Ibid.*, p. 11

²⁷ The accusation appears in the very title of his book

²⁸ There is also a significant element of class warfare in the accusation. As Peter Osborne wrote in his *Spectator* article, "When the original privatisation took place, Labour set about making Railtrack the symbol of their brilliantly successful and scurrilous campaign against "fat cats". Whenever the company dared to announce a dividend, it was condemned for grand larceny. Profit, in a typical piece of financial illiteracy, was denounced as theft. The directors were hounded in a vicious, personalised campaign. "They are a bad bunch, I am afraid," said transport spokesman Clare Short before the last election. From the very start, Labour treated the directors of Railtrack like criminals. In Labour's victory conference of autumn 1997, John Prescott read out the names of each director in turn, sneering. At a time when Tony Blair led his party, kicking and screaming, towards capitalism, a concession was made for Railtrack. It was allowed to remain in place in Labour demonology, a symbol of hatred of the bosses and the class war."

²⁹ The term "market failure" is sometimes applied to Railtrack, but it should be apparent from the discussion that Railtrack was not really a market entity, being merely a private sector channel for government funding and, often, instructions. There was, essentially, no market to fail.

³⁰ *Op cit*, p. 6

³¹ *Ibid*, p.7

³² *Ibid*, p.8

³³ *Ibid*, Executive Summary

³⁴ *Ibid*, Executive Summary

³⁵ See DfT press release at http://www.dft.gov.uk/pns/displaypn.cgi?pn_id=2005_0046

³⁶ Although there is no reason to assume that this must be guaranteed by government; given freedom, fragmentation may well naturally evolve.

³⁷ March 13, 2004

³⁸ *Ibid*

³⁹ There is considerable public hostility to Brussels' role in framing much of British legislation, while British attempts to reduce EU powers are met with resistance by both the EU and many other member states. A confrontation over this issue could have much wider political implications, and so British governments are unlikely to force the issue unless the major parties have a change in attitude towards Europe.

⁴⁰ "The Folly of Rail Re-regulation," Americans for Tax Reform Policy Brief, 1999. Available at <http://www.ATR.org/content/html/1999/090199pb.html>

⁴¹ While the reforms were passed by Congress, much of the credit must go to work undertaken by the Carter administration, which first proposed deregulation as an option.

⁴² The ICC was later replaced by the Surface Transportation Board (STB), which now has an annual federal budget allocation of roughly \$10 million and operates on the presumption that rail rates are reasonable.

⁴³ Ferrara, *op. cit.*

⁴⁴ Christopher C. Barnekov and A.N. Kleit, "The Efficiency Effects of Railroad Deregulation in the United States", *International Journal of Transport Economics*, Vol. XVII, No. 1, February 1990, p.36.

⁴⁵ "Will new regulation derail the railroads?" Competitive Enterprise Institute, 2001, available at <http://www.cei.org/pdf/2899.pdf>

⁴⁶ "Separation Philosophy of the European Union — Blessing or Curse?" Carlo Pfund, LITRA, 2003

⁴⁷ Mr Cox was titled Chief Operating Officer, which in American railways is often used to mean the man who runs the company, but Mr Cox's responsibility was running the railway.