OCCASIONAL PAPER 23

CRI
CENTRE FOR THE STUDY OF REGULATED INDUSTRIES

BRITISH RAIL PRIVATISATION ~ COMPETITION DESTROYED BY POLITICS

Stephen Glaister

Fundación Rafael del Pino
Conference: Competencia en el Transporte Ferroviario

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PREFACE

The CRI is pleased to publish Occasional Paper 23 on **British Rail Privatisation ~ Competition Destroyed by Politics** by Stephen Glaister, Professor of Transport and Infrastructure, Imperial College London. This paper was prepared for a conference entitled 'Competencia en el Transporte Ferroviario', held on September 16th and 17th, 2004 in Madrid. The paper and conference were sponsored by Fundación Rafael del Pino, Rafael Calvo 39, 28010 Madrid. © *Fundación Rafael del Pino 2004*, which we are pleased to acknowledge.

Professor Glaister focuses in particular on the issue of regulatory consistency. In effect, he suggests that having chosen (or adopted from the previous government) a particular model to deliver rail services, the government then has a responsibility to maintain that policy, unless there are good reasons for changing it. Where change is required, the reasons and consequences should be set out, debated and appropriately implemented, with both parliamentary accountability and regard to the principles of good regulation. His thesis is that, whilst alternative models could have equally been made to work, the government has acted to undermine the chosen model - a competitive rail industry - without explicitly choosing an alternative model. This is likely to achieve the worst of all outcomes, and Professor Glaister sets out a compelling story in that regard, and it acts as a cautionary tale for regulatory policy and accountability in general.

The CRI would welcome comments on the occasional paper. Comments should be addressed to:

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The views of authors are their own, and do not necessarily represent those of the CRI.

Peter Vass
Director, CRI
November 2004

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1 INTRODUCTION

Competition was at the heart of the British railways reforms of the 1990s. And it was competition in an extraordinary number of dimensions: for passengers, for contracts to run trains, for freight customers, for labour, for provision of rolling stock and for provision of engineering services. The structure was intended to enable competition to work effectively at all of these levels.[1] Although dauntingly complex, imperfectly articulated and implemented in an imprudent hurry it worked reasonably well for a period of some years: it seemed to be meeting the objectives of the policy.

Unfortunately, compromises were made at the very start which undermined the conditions necessary for effective competition in some parts of the industry. Then, over time, the political sensitivity of the national railways tempted central government into intervening in a number of ways which cumulatively proved fatal to the competitive processes. By 2004 the failures of the administration of the railways had led the whole system to become discredited in the eyes of most of the general public. A government review of was published in July but the controversies continue.[2]

This paper points out some of the ways in which successive British governments weakened competition. There were important shortcomings under both the Conservative government which implemented the policy and the Labour government (after May 1997) which sought to change it in several ways. The paper does not seek do argue that competition is a good or a bad mechanism: history shows that delivering railway services can be achieved through an extraordinary range of alternative institutional mechanisms. It argues that the British experience illustrates that competitive mechanisms can be made to work successfully in national railway systems if, but only if, they are correctly set up and then left unmolested by the political process - a requirement that it is hard to meet in practice. The paper suggests that the outcome of the railways review of July 2004 does little to solve the current problems. It further weakens competition but fails to put anything effective in its palace. Further reform is inevitable.

Principles of competition and risk transfer

Whilst this is not the place to expound the theory of competitive markets and competitive procurement it is useful to mention some principles for later reference.[3] In its purest form a competitive market is one in which there is a large number of agents willing and able to offer the commodity or service at the going price - the ‘supply price’. There are no barriers to entry to or exit from the business and all potential competitors have equal access to relevant knowledge, skills, land and equipment. In this environment all agents who are trading will be

[1] Foster C D and Castles C (2004), Creating a Viable Railway for Britain - What Has Gone Wrong and How To Fix It, typescript.
[2] Department for Transport (2004), The Future of Rail, Cm 6233, July.
[3] See for example, Domberger S (1998), The Contracting Organisation, A Strategic Guide to Outsourcing, Oxford.

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and will remain fully efficient. That is, they will produce at the lowest possible cost. An inefficient trader would soon be displaced by an efficient entrant. Therefore the purchaser can be confident that he buys at lowest available cost.

The earning of profit through the provision of public services is a confused and controversial subject. 'Economic' profit is calculated after taking account of the three costs of conducting business: operating expenditure, capital consumption (represented by depreciation) and the cost of capital finance. 'Accounting' profit may be defined as either operating profit before financing costs, net profit after interest or retained profit after dividends, interest and tax. None of these is normally the same as economic profit. Although accounting profit may be observed in competitive equilibrium there will be no economic profit: free entry competition eliminates that. Revenues will just be enough to remunerate the inputs, including labour and managerial skills and including the return on capital employed commensurate with the risks as assessed by the financial markets. The observation that private sector providers make accounting profit does not necessarily mean that this profit is somehow wasteful and something that public procurement can economise on. The inputs, including capital, have to be remunerated either way and capital has a cost even if, as is often the case, it is hidden because it is not transparently accounted for by a public sector provider.

In practice competition is less than perfect to some degree. Anti-competitive practices, barriers to entry and technological characteristics such as natural monopoly can create various degrees of dominance and that dominance may or may not be used to generate economic profit (sometimes referred to as 'rent'). In many cases anticompetitive practice and abuse of dominant position are illegal under European law and prevented either by explicit economic regulation of price, quantity or quality, or through the courts. However, in some railway contexts they are tolerated or even encouraged. For instance, the earning of monopoly profits can be used to cross subsidise unremunerative activities and thereby reduce the call on the taxpayer necessary to fund a public service obligation. Similar considerations apply in markets for inputs. Importantly, as we shall argue, the competitive market for labour - or the lack of it because of barriers created by labour unions and government intervention - is a core issue in the economics, policy and politics of national railways.

The British railway industry still retains much the same structure as was created at privatisation. A fundamental principle was, and to some degree remains, that both privately owned infrastructure providers and train operators are given incentives to be efficient - and thus to reduce the call on the taxpayer - by being made to suffer the financial consequences of their inefficiencies. In other words, as for any other shareholder company, a discipline is supposed to be created by transferring the business risks from the taxpayer to companies in which the values of the owners' assets are at stake. Conventional disciplines are supposed to apply whereby failure to do well for the shareholders would normally be punished through the competitive market for corporate control, the threat of takeover and replacement of the management.

A question posed in this paper is whether this philosophy can be effective, given the manifest inability or unwillingness of government to enforce risk transfer in practice and the fact that, in any case, Network Rail now has little private capital at risk.

The importance of competition in the history of British Railways[4]

It is often forgotten that competition and the seeking of private profit was fundamental to the development and operation of the British railway system throughout most of its existence. On several occasions over the years the government of the day has felt uncomfortable with this and has intervened to achieve particular public interest objectives as they saw them. This has not always proved beneficial. History has been repeated more than once and there is a danger that the new policy of July 2004 will again repeat the failures.

Given the success of private enterprise in so radically improving transport provision it is not at all surprising that the nineteenth century liberal politicians were content to ‘leave it to the market’ to choose how and where to invest in service-provision whilst using state intervention to limit monopoly profits and protect rights to life, liberty and property. They thought these rights should be defended, where necessary, by state regulation against large or monopoly enterprises. Thus one of the earliest pieces of rail legislation was the Railway Regulation Act 1840 empowering the Board of Trade to appoint railway inspectors to check new passenger lines and receive information about rail accidents. The Whigs (or Liberals) were more willing to intervene in a ‘utilitarian’ search for efficiency, and to defend rail users, especially small businesses. The Tories (or Conservatives) were more protective of property-owners’ rights. But all were ‘free market’ when contrasted with the Labour party of the 1930s and again of the late 1990s, which expected to plan and coordinate transport through centralisation and nationalisation.

Rail companies needed parliamentary approval to come into being, but parliament took only limited interest in the ‘network’ which was being created, *ad hoc*, from local lines. In 1844, the growing pressure of private rail bills encouraged MPs to set up a select committee on railways. This wanted the construction of lines to be more rational. It thought the duplication of lines would take trade from existing companies without necessarily keeping prices down. Between 1845 and 1847 Parliament approved 425 acts covering more than 8,500 miles of railway.

The oligopolistic competition of the early 1840s soon gave way to a process of consolidation which progressively limited competition as moves towards the creation of a more coherent rail network were taken by the rail companies themselves. The Railway Clearing House had already been established by companies to facilitate through traffic across company boundaries when it was made statutory in 1846. The same year also saw the passage of 18 acts sanctioning railway company amalgamations. The taking over of weaker companies by successful ones from the 1840s improved co-ordination and efficiency without government having to act. From the mid-1850s until after the First World War the railways enjoyed an almost complete monopoly of inland passenger and freight transport. Parliament worried about the establishment of monopolies in certain regions, but in 1872 a select committee concluded that railway amalgamations were inevitable and perhaps desirable. Product emulation, such as the copying by all railways of Midland Railway’s third-class carriages, had improved and standardised service quality. In 1909, following another wave of amalgamations, a Departmental Committee on Railway Agreements and Amalgamations concluded that some regulation of cooperation would be to the advantage of the public as well as the railway companies.

[4] Parts of this section are adapted from Glaister S, Burnham J, Stevens H and Travers T (1998), Transport Policy in Britain, Macmillan.

In these circumstances the main role of government was to defend the trading and travelling community against the monopoly power of the railway companies. Gladstone's 1844 Railway Regulation Act gave the government the option of revising prices downwards if a company paid dividends of 10% or more, and the right of compulsory purchase after 21 years, though these options were never exercised: the legislation had become so mangled in Commons committee that it became unusable.[5] Also, companies were required to provide one return 'Parliamentary' passenger train a day at a reasonable speed and maximum fare. In 1854, under a coalition government, parliament passed the Railway and Canal Traffic Act which required each railway company to take all trade offered (to be 'a common carrier'). They had to set and publish the same levels of fares and charges to all for any particular service (not give 'undue preference'). Though the state did not intervene directly in rail provision, neither did it allow rail companies to set tariffs flexibly on strictly commercial criteria, or pick and choose between the types of traffic they would carry.

Even so, under the multitude of private acts of Parliament the railway companies retained extensive scope to exploit their monopoly position and the process of railway amalgamations proceeded. Eventually the Railway and Canal Traffic Acts of 1888 and 1894 required companies to set maximum rates which could not be raised without the permission of the Railway and Canal Commission (a Board of Trade-appointed quasi-autonomous non-government organisation). This act was to prove all too effective in constraining the commercial flexibility of the railway companies. They could not raise their rates without permission, which was hard to obtain, and they dared not lower them, even to attract new business, for fear that they would be unable to raise them again if the lower rate proved uneconomic. The combined effect of more than half a century of monopoly domination of the transport market, together with a degree of government regulation that tended to stifle any commercial initiative which might have survived, left the railways ill-prepared to face effective competition from road transport when that began to emerge after the First World War. There is a lesson here for the present government who have recently decided to take setting of fares into their direct control.

During the First World War the railways had been controlled by the government and run by an executive committee of rail company managers. In 1919 a decision had to be made on how the railways should be returned to the private sector. Coordinating and pooling arrangements during the war had saved costs, suggesting there should not be a return to the pre-war network of more than 130 separate lines and 21 major companies. Four regional groupings were created.

Thus four 'historic' railway companies were less the product of private enterprise than of the rationalising efforts of government, parliament and the Department of Transport, as promulgated in the Railways Act 1921. The charges set by these railways, each given a virtual territorial monopoly, were in government hands. The act gave little incentive for rail companies to increase efficiency or improve services. Rules on revenue and prices meant companies would retain only a small proportion of any economies made. Employees could not be given a worse post in a new company than they held in a pre-war company, which resulted in over-manning at senior levels compared with firms in other sectors. The heavy hand of price regulation seriously handicapped the rail companies in competing with road transport. Rates had to be published and were determined on a value for weight basis, which implied high charges for carrying valuable manufactured goods, and low charges for bulky heavy commodities like coal. The charges had to be the same right across the network and could not show undue preference to any particular customer over another. The regulatory

[5] See, Foster C D (1992), Privatisation, Public Ownership and the Regulation of Natural Monopoly, Blackwell.

arrangements, made on the assumption the rail industry was a monopolistic predator, made it difficult for rail to compete effectively with road transport.

By the end of the 1920s the railway's effective monopoly was reduced. Rail's advantages over road on freight were mainly in heavy, bulky goods and over long distances - but heavy industries were in decline and British industrial geography was relatively compact. In passenger transport, rail was already losing first-class fares revenues in the late 1920s because that section of the population could afford cars. Rail had chosen to compete on speed of journey, but not on costs or quality of service; and it was nearly always at a disadvantage on ease of access. Whereas at the beginning of the century it had seemed that road and rail transport would be complementary (operating in different markets), they were now competing for the same goods or travellers. The demand for 'co-ordination' of road and rail in the 1920s came from the railway companies, worried about the trade they were losing to road traffic. The road transport lobby's suspicions were fuelled by the rail companies' campaign to run road services.

During the Second World War the government took overall control of rail transport. For the post-war Labour government there was no question of returning the controlled enterprises to the private sector. The Transport Act 1947 created the British Transport Commission (BTC), operating through separate executives dealing with rail, canals, road transport, and London transport. In the light of the controversy in early years of the twenty first century about private profit and the wish to bring the rail industry back under more direct public control, the words of the Minister of Transport in 1949, Alfred Barnes, are interesting: the main objective of socialising the transport industry 'was to consolidate the various elements of transport… into a single whole which would operate as a non-profit making utility service at the least real cost to trade, industry and the travelling public'.

Because the purpose of the BTC was to provide an integrated system, financial control was given to the BTC, not the separate executives. This arrangement perpetuated the accounting practices of the railway companies by allowing cross-subsidy between different parts of the operation, and between different financial years. It hid changes in rail use and allowed the postponement of difficult decisions. BTC's charges were regulated by a Transport Tribunal and ministerial directives, and both the Tribunal and ministers used their powers to limit BTC's proposed fare increases Manufacturers exploited rail's value-based pricing structures and obligation to take all trade, by sending 'expensive' loads in their own lorries, and 'difficult' loads by rail. Changes were in any case taking place in the relative popularity of the two modes of transport.

Although the 1947 British Transport Commission was set up to provide 'an efficient, adequate, economical and properly integrated system of public inland transport', extensive government ownership failed to deliver the benefits which had been hoped, and over the succeeding fifty years, especially since 1979, most of the transport industries were returned to private ownership with an emphasis on the benefits of commercial disciplines and competition. Between 1951 and 1979 the evolution of transport policy was more pragmatic than ideological, with many of the more important developments carried over from one government to the next even when the political direction had changed. Under the Labour governments of 1964-70 there was a brief return to policies favouring co-ordination through integration and public control, but even in the 1960s recognition of the benefits of competition and a more commercial approach to the provision of transport services continued to gain ground.

In 1962 the government abolished the BTC, and reconstituted the British Railways Board as a distinct public corporation, with its own semi-autonomous board. They put an outsider, Dr Beeching, in charge. The railway would no longer have to take all goods as ‘a common carrier’ or have its charges approved by the Transport Tribunal. While remaining within the public sector, it was promised more commercial freedom.

The reforms broke up what was left of the ‘integrated transport’ organisation which the BTC had been supposed to bring about. Moreover, Beeching’s investigations into the rail network broke it up financially so that for the first time the viability of each part became explicit. His 1963 report on The Reshaping of British Railways was criticised for its narrow definition of costs, for example not taking account of social or economic development needs, or of savings in urban congestion or environmental damage. His recommendations for widespread closures of loss-making stations and lines horrified many politicians, especially in the Labour government which had to implement his closure programme after winning the 1964 election, and some loss-making lines remained open into the 1990s. But the Beeching exercise was a necessary first step in ‘transparency’, relating public subsidy to specific lines and services so that decisions about whether to keep them open could be based on accurate information.

2 PRIVATISATION AND DEREGULATION

Between 1979 and 1997 policy was characterised by a much more radical commitment to privatisation and deregulation. When Mrs Thatcher's Conservative party came to office in 1979 a main concern was to remove barriers to competition; to foster the free market in the belief it would encourage efficiency.

The Conservative government subsequently discovered additional motives for privatisation. The sale of British Telecom demonstrated the substantial sums privatisation brought to the exchequer: it counted as negative public expenditure. It was thought too that privatisation could be used to introduce the experience of share ownership to a much wider range of people, in the expectation they would continue to hold shares and thus perhaps become more sympathetic to the values espoused by the Conservative party. By 1988 the Thatcher government, having privatised the bus and coach, telecommunications, gas, water and electricity industries, had considered rail privatisation in sufficient detail to identify five options - the sixth was the *status quo*. They were:

1. privatisation of British Rail (BR) as one railway and one company - the option favoured by the British Rail Board;
2. privatisation of BR as a single holding company with a range of subsidiaries - a decentralised version of the previous option;
3. establishment of a track authority or company to own infrastructure with separate private companies operating the services;
4. division of BR into parts based on geography - similar to the arrangements 1923-47;
5. division of BR into business sectors on the basis of the then existing management structure; InterCity, freight, parcels, Network SouthEast, Regional Railways;
6. retention of BR in public ownership - favoured by a majority of the public, and a large minority of MPs.

The government could not come to an immediate agreement on any option, but the debate was reopened when the government under John Major (successor to Mrs Thatcher as leader of the Tory party) was drawing up its manifesto for the 1992 general election. The government's view, in the words of the secretary of state for transport, introducing the bill to MPs, was that:

> "As an organisation, BR combines the classic shortcomings of the traditional nationalised industry. It is an entrenched monopoly. That means too little responsiveness to customers' needs, whether passenger or freight; no real competition; and too little diversity and innovation" (House of Commons Debates, 2 February 1993:124).

Option (3) was eventually selected in spite of the preference of many (including, allegedly, the Prime Minister) for option (4).

The original intention was to actually privatise Railtrack (that is, to sell the company in shares to the general public) at some ill-defined point in 'the medium term', certainly after the next general election. As a transition, in 1994 it was set up as an internal division of British Rail and in 1995 it became a separate government-owned company (GoCo: that is, a company with a normal commercial accounting and governance structure but with all the shares held by government). The relevant expenditure was kept within a ceiling set by the Treasury. Each year Railtrack's allocation fell mainly because of a belief that maintenance and renewals costs would fall. Railtrack could not have increased its expenditure under that regime even if it had wanted to.

A decision to accelerate the actual privatisation in order to bring it ahead of the 1997 general election came, after at least one change of minister, for two reasons: advice from the financial markets (the City) following unexpectedly difficult sales of other parts of the rail business, principally of the freight companies, but also because of a belated wish to get everything done in advance of the election. In turn, that may have been partly in order to give the exchequer access to the sales proceeds at the earliest opportunity and partly because it was becoming clear that there would likely be a change of government and Labour would certainly not have completed privatisation unless they received it as a done deal. The confusion and poor decision-taking caused by the resulting scramble is related in Foster.[6] He demonstrates that this rush, coupled with an inability of the politicians to come to clear decisions about what they wanted and imperfect administrative processes led to an outcome that was much less satisfactory than it could have been. The prospectus for the sale of shares was issued in 1996 and the privatisation was duly completed before the 1997 general election in which, as widely expected, the Conservatives were defeated by Labour.[7]

Competition and privatisation of rail services

The problem the government of the early 1990s was trying to solve was a familiar one with national railways - how to reduce the demands on the national taxpayer without unacceptable reductions in the scale of railway services. One main way this might be achieved was thought to be through generating new user revenues by commercially driven innovation and marketing. The other was by reducing costs, principally through introducing the discipline of commercially driven competition in the labour markets. This last had been seen as one of the major sources of success in the five utilities previously privatised. This experience included the bus industry which had been heavily unionised, as were the railways and in many cases by the same unions.

In the original concept the following are some of the dimensions of competition that were envisaged:

- competition for passengers by privately owned train operators, each gaining access to a regulated infrastructure company;
- twenty five contracts for specific passenger service groups referred to (perhaps inaccurately) as ‘franchises’ were to be let by competitive tender and were to be competed for again after they expired in seven (in some case fifteen) years;
- in order to facilitate easy entry of passenger train operators to the business with relatively little capital, three competing rolling stock leasing companies were created to own the existing rolling stock and to acquire and lease out new stock on a commercial basis;
- the rail freight businesses were to be sold as a number competing private businesses;

[6] Foster C D (2005 forthcoming), British Government in Crisis, Hart Publishers, Oxford.
[7] SBC Warburg (1996), Railtrack Share Offer, Prospectus, 1 May.

- the infrastructure owner and operator was to be kept as a regulated monopoly, called Railtrack. It was to be a private shareholder company, subject to the forces of competition for corporate control in the normal way. It owned the signalling and fixed infrastructure. Its property portfolio included stations, railway land, buildings, installations and light maintenance depots, many of which were leased to train operators. However, 14 large mainline stations remained under Railtrack's direct control. It was responsible for central timetabling and co-ordination of all train movements, signalling, and planning investment in infrastructure and ensuring it is carried out. It was responsible for safe operation of the network under the supervision of the Health and Safety Executive.

Railtrack's sole source of income was to come from charges for access to its facilities to users, the train operators, except that the secretary of state retained the power to give direct capital grants for freight facilities if justified on public interest grounds. Railtrack was created with relatively few direct employees (about 12,000). It procured most of the services it needed on the open market. In particular engineering services for maintenance, renewal and enhancement were bought in. The existing rail engineering capabilities were broken into thirteen companies and sold to the private sector. It was taken for granted that each of the myriad commercial relationships created between customers and providers needed to be codified in explicit commercial contracts. That these were successfully created in a relatively short time is a tribute to the efficiency, capacity and the inventiveness of the legal services available in the UK - and to the ready availability of the funds necessary to remunerate them.

The privatised, regulated structure was complex.[8] The relevant legislation is very similar to that for the telecommunications, gas, electricity, water and rail industries which created the system we have come to know as the UK model of utility regulation. In each case an independent regulator (formally answerable only to the courts and not to ministers) has public interest duties including a duty to review charges from time to time. Typically the regulators have functions in approving licences, access agreements and other contracts entered into from time to time and they may be called upon to referee the way in which these contracts are administered in practice. Licences or access agreements make provision for the regulator to adjust rates of charge at periodic or extraordinary review. Regulators can carry out a periodic review at any time but a normal pattern has become established on a five-year cycle. At periodic review the regulator will take into account current circumstances - including current asset condition, cost of capital and costs of other inputs - and will determine appropriate charges for the next control period. That is done with reference to current circumstances and anticipated future needs. The regulators make their determinations in accordance with public interest duties (eg, Section 4 of the Railways Act 1993).

[8] The detail is set out in:
Foster C D (1994), The Economics of Rail Privatisation, CRI Discussion Paper 7, April and reprinted in The Development of Rail Regulation, CRI collections Series 2, November 2003, University of Bath.
Lawrence G (2001), The Rail Industry in Great Britain, Institutional and Legal Structure 2000/2001, Industry Brief, Centre for the study of Regulated Industries, University of Bath.
National Audit Office (2000), Ensuring that Railtrack Maintain and Renew the Network, HC 397 Session 1999-2000, April.
National Audit Office (2004a), Network Rail: Making a Fresh Start, HC 532.
Office of the Rail Regulator (2000), The Periodic Review of Railtrack's Access Charges: Final Conclusions, Vols I & II, October.
Helm D (2000), A Critique of Rail Regulation, The Beesley Lectures in Regulation, IEA and London Business School, October.
Bartle I (2004), Britain's Railway Crisis - A Review of the Arguments in Comparative Perspective, Occasional Paper 20, Centre for the study of Regulated Industries, University of Bath.

The rail regulator, appointed by the secretary of state, is independent. His or her approval is required for all access agreements between Railtrack and passenger and freight train operators. Railtrack has a network licence administered by the regulator. Any train operator requires an operator licence. Operators include: franchised passenger service operators; independent, non-franchised (that is, ‘open access’) passenger service operators; and freight train operators. The regulator has statutory functions in four main areas: the granting, monitoring and enforcement of licences to operate railway assets; the approval of access agreements between facility owners and users of railway facilities; the enforcement of domestic competition law; and approval of railway line closures.

The regulator’s duties are to protect the interests of both providers and users of rail services, to promote competition together with efficiency and economy, to promote the development and use of the network, to safeguard through-ticketing for the benefit of the public, and, crucially for what happened later, to ensure that Railtrack does not find it unduly difficult to finance its activities providing that it behaves in an economic and efficient manner. In fulfilling those duties, the regulator must take into account the financial position of the franchising director (after 2001, the Strategic Rail Authority), whose budget was decided by government. The regulator can vary licences by agreement: if the licence-holder does not agree, the matter could be referred to the Monopolies and Mergers Commission (later the Competition Commission). The regulator ensures that arrangements for allocating train paths and settling timetable disputes were fair and reasonable. In relation to the monopoly supply of railway services the regulator has concurrent jurisdiction with the director general of fair trading.

A significant difference between privatised rail and other British regulated utilities was the role Parliament gave the regulator over the commercial contracts which grant infrastructure users permission to operate. In other industries, the regulators’ role is based primarily on the licences the operators hold. In the case of the railway industry however, much of the important economic regulation - particularly the control of prices charged for the use of railway assets - is based on access agreements not licences, and the regulator’s approval of every access agreement is required.

The regulator has considerable powers. However, there are many things over which he or she has no power. Many contracts were not regulated, such as the terms of leases for rolling stock and for stations, and the contracts between Railtrack and providers of engineering services (the greater part of Railtrack’s expenditure). Most important, and most surprising to the general public, the regulator has no power to regulate passenger fares. This power belonged to the Office of Passenger Rail Franchising (OPRAF) (headed by the franchising director) through the contracts offered for passenger franchises, presumably on the grounds that fares regulation has direct implications for subsidy and therefore for government expenditure. Hence it could not be left in the hands of a person like the regulator, not accountable to Parliament.

The franchising director, accountable to ministers, is unique to the railways. This was necessary because, unlike the other utilities, the railway could not be expected to become self-financing: public subsidy was inevitable and it was the franchising director’s job to administer it. Financial support to the railway passed through his office with the exception of certain freight grants and any capital grants. His function was to define rail passenger franchises and sell them to train operating companies using a competitive tendering procedure. Arrangements for through-ticketing and concessionary fares are enforced through these agreements. The Office of Passenger Rail Franchising’s other responsibilities included encouraging investment, improving services, and developing arrangements to ensure the continuation of some of British Rail's former facilities, such as concessionary travel for staff, through-ticketing and certain travel cards and railcards.

The invention of the OPRAF was an ingenious device which allowed a publicly accountable body to administer taxpayer funding, whilst maintaining largely commercial incentives for all the service providers in the industry. Although a part of government and answerable to ministers it had a separate budget and considerable discretion about how that budget was to be allocated. To that extent its actions were transparent to the general public. One beneficial consequence, for instance, has been the publication of annual reports identifying the amounts of public money being spent on subsidies to the various train operating companies (TOCs). This kind of information is essential for proper public debate of taxation and spending policies and it was unavailable before privatisation.[9]

Some people felt from the outset that the roles of the two regulatory offices - the Office of the Rail Regulator and the Office of Passenger Rail Franchising - were confused and poorly understood (Foster, 2005). A recurring proposal over the years has been that they should be combined into the one office.

Explicit policy and political risk

The railways policy ultimately failed because of the damage caused by political risk. This came about because the privatisation legislation was pushed though in 1993 by a Conservative government (despite considerable opposition within the party) but a Labour government was elected in 1997. The railway was traditionally an important power base for the Labour party and, as we have noted Labour had always favoured 'integration', state ownership and centralised control of the railways. It is hard to think of an industry that the traditional Labour party would have been less willing to see privatised and less likely to leave alone once privatised apart from coal mining. In opposition the party signalled this very clearly and all should have understood the magnitude of the political risk. As Winsor, rail regulator from 1999 to 2004 has said, "*it is no good the private sector complaining that governments are political*".[10] His May 2004 response to the government's rail review is an admirably clear statement of the legal and constitutional position - something that is frequently not well understood by commentators. He identifies clearly the importance of the 'iterative' planning process between the government and the regulator and the irresponsibility of the government in not fulfilling its duties to clearly specify outputs and hence the trade-offs with subsidy.

The signal that there were severe political risks was transmitted in particularly simple and explicit terms in the prospectus for the Railtrack share offer (SBC Warburg, 1996) which contains a formal statement by the Labour party, then in opposition. The prospectus reproduced the text of a speech dated 29 March 1996 by Claire Short MP, the Shadow Transport Secretary, which included:

> "… The Labour party is totally opposed to the privatisation of the railways including Railtrack and will campaign vigorously to prevent it happening. Should the flotation of Railtrack PLC proceed a Labour government will make

[9] See, for example, Strategic Rail Authority (2004), Britain's Railway Properly Delivered, Annual Report 2003-2004, Appendix 3.

[10] Winsor T (2004a), The Relationship Between the Government and the Private Sector: Winsor-v- Bloom in context, Incorporated Council of Law reporting, 5 April.

good its commitment to a publicly owned and publicly accountable railway by taking the following steps:

1. through regulation, it will seek an integrated railway system. It will amend the Railways Act 1993 to enhance the accountability of the rail regulator to the secretary of state; strengthen the powers of the regulator to ensure that the system and its assets are managed efficiently in the public interest; and take measures to ensure the public get the best value for money from the public subsidies going to the railways including in particular fair access charges to encourage more intensive use of the track; and ensuring the proceeds from investment in property development are reinvested in the railway system;

2. reconstitute British Rail as a fully publicly owned, publicly accountable company holding the public's interest in the rail network and charged with encouraging and fostering partnership between public and private finance in the rail network on a long term basis to secure future investment; and

3. dependent on the availability of resources, and as priorities allow, seek, by appropriate means, to extend public ownership and control over Railtrack…

… Labour is confident that its programme for rail can be carried through using the power to regulate, the power of the public subsidy and the power to acquire ownership. We do not believe that the public will or should be willing to continue to provide an annual input of public funds of as much as £2bn without proper public accountability and a fair return on public investment.

Potential investors in Railtrack should be aware that a future Labour government will pursue its public interest objectives for the railway by the use of existing mechanisms in the regulatory and contractual arrangements which presently apply to Railtrack. I am today spelling out in some detail Labour's approach to the regulatory regime. I do so in order that institutions contemplating investment in Railtrack can be absolutely clear about Labour's intentions and make their judgements accordingly.

The regulatory arrangements that are already in place give the rail regulator considerable powers to secure changes to the regime as it applies to Railtrack, if necessary against Railtrack's wishes. Those changes may be made so as to alter Railtrack's obligations and thus its priorities, in order to achieve the objectives of the public interest… .

The powers of the rail regulator are central to the achievement of the objectives of a Labour government. The regulator will be the immediate instrument of change. Some changes will require to be made in relation to the duties, control and accountability of the rail regulator. These changes will be made by primary legislation early in the life of the Labour government. In legislative terms, the changes are very simple indeed. In political and economic terms they will be very important. The effect of the changes will be that the rail regulator will be made answerable to the secretary of state to a far greater extent than is now the case. The powers of the secretary of state to remove the regulator from office will also be widened".

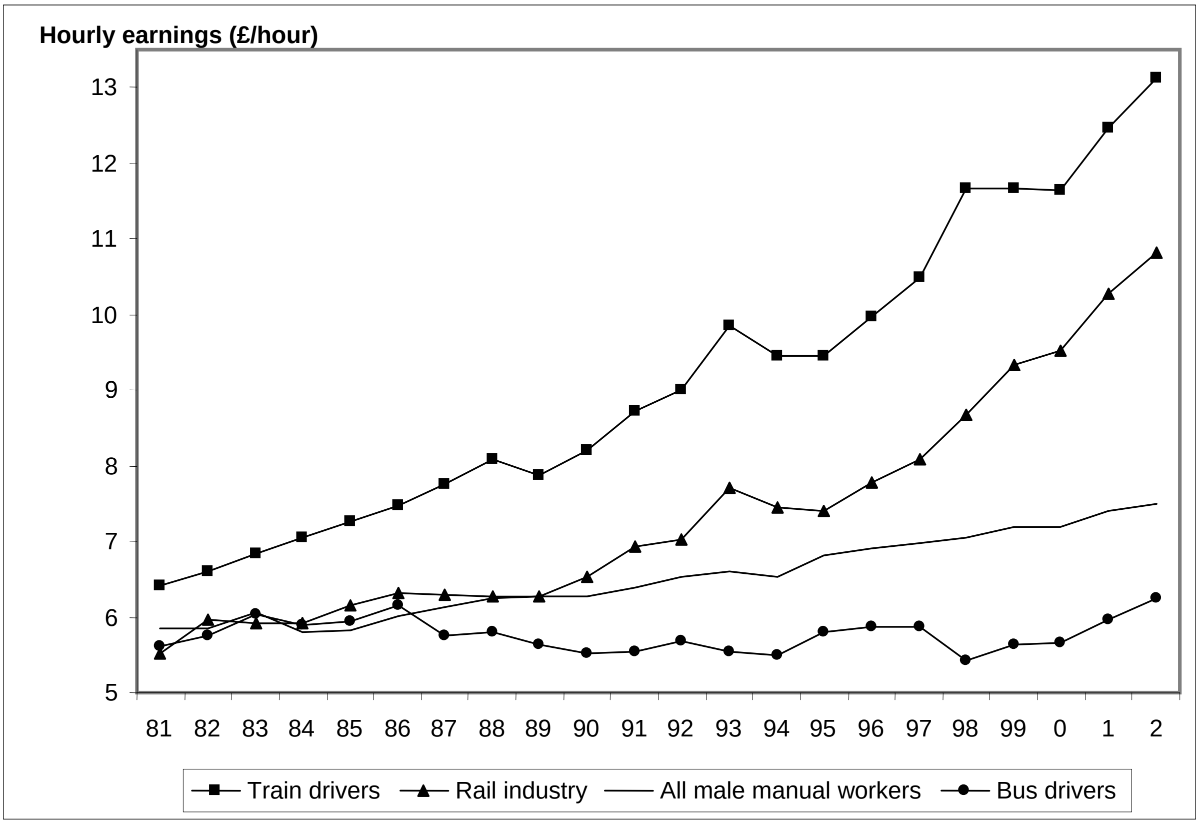
Subsequent events have demonstrated the importance of this strong and threatening statement, though it seemed to be ignored by the markets at the time and also in the early years of the Labour government (from 1997). It has since been largely forgotten.

Competition in labour markets

It was an explicit part of the 1984 policy on deregulating buses outside London that costs would be reduced by enforcing competition in the market for labour. It had been observed that earnings for drivers in the regulated bus industry were higher than drivers in comparable, competitive industries. The white paper insisted that in order to achieve the full force of labour market competition it was necessary to break the state monopoly bus company into a large number of small companies and to privatise them as well as to deregulate the industry.[11]

Figure 1 shows full time average hourly manual earnings for male bus drivers and for all male manual workers. It illustrates the impact of the policy of privatising and deregulating the bus industry. Before the policy was enacted in 1985 average hourly earnings of bus drivers were slightly higher than those for manual workers as a whole. Afterwards there was an immediate fall in earnings and the gap between them and the average has broadly widened over the period (although bus pay rates have accelerated in recent years as general labour market conditions have tightened). This undoubtedly contributed to the reduction in real unit bus costs of over 40% which was achieved after bus deregulation.

Figure 1: Hourly earnings of full time male railway workers, train drivers, bus drivers and all full time males (1997 prices)



Source: New Earnings Survey, various years

[11] Department of Transport (1984), Buses.

A similar result was achieved for buses in London albeit over a longer period of time. There a programme of competitive tendering route-by-route was progressively introduced from 1985 in which the state-owned operator, London Buses Limited, was placed in direct competition with privately owned providers. This was followed by privatisation of the state-owned bus company in 1993. By 1995 the real unit cost of bus operations in London had fully halved compared to 1983 and competitive route tendering was undoubtedly the most important factor in achieving the reduction in labour costs which made this possible.[12] A crucial ingredient of this policy was the fact that the contracts were not too large and were of reasonably short duration - three years in the first instance and more recently five years. At contract termination there was an open and reasonably actively contested competition for the contracts.

Both in London and outside it active competition in the bus labour market seems to have survived the tendency for the smaller companies created in the mid 1980s to agglomerate into relatively few territorial companies. The state owned monopolies - the National Bus Company and London Buses Limited - were heavily unionised but the unions seemed unable to protect the terms and conditions and the level of union membership has now fallen considerably. Apart from the direct competitive pressures created by the policies themselves another important feature of the period was an aggressive stance towards labour relations by the governments of the day, aided by relatively high unemployment and a generally ‘slack’ labour market.

There can be no doubt that this effective introduction of competition into the bus labour markets has meant that the call on the taxpayer is now much less than it would otherwise have been - and that it has staved off a major contraction of the bus industry.

Figure 1 shows that this pattern was not repeated in the case of the railways. This may partly explain why government continues to find it so hard to control costs and subsidies in the rail industry. In the 1980s the average hourly earnings in the rail industry were close to the average for all manual workers and those for train drivers and assistants were about 10% higher. After the structural change of 1993 rail industry earnings rates moved ahead of general earnings by over 10%. After privatisation in 1996 rail industry earnings rates accelerated ahead of general earnings and by 2002 they were nearly 50% higher. Real earnings of train drivers moved ahead of general rail industry earnings throughout the period, and they appear to have accelerated in the more recent years so that by 2002 they stood 80% above general manual earnings.

Of course, this might just be a reflection of rapidly increasing productivity and, if the number of employee-hours has fallen enough to offset the hourly wage increase then the total wage bill could have fallen. Certainly, railway output has increased since privatisation but it is not known how labour productivity may have changed and how that may be reflected in real earnings. However, it seems likely that the onset of aggressive competition that occurred in the bus labour market did not occur in the rail labour market.

Maybe there was some reason that the labour unions had more success in protecting the position of their memberships in railways than in buses. One plausible explanation for the difference lies in the greater flexibility of buses and the difference in high level political salience of the two modes. Bus routes come and go. If a bus company runs into financial difficulty with a route it will quickly withdraw and the route may or may not be taken over by a competing company. In short the forces of competition are effective at punishing attempts

[12] Glaister S and Travers T (1995), Liberate the Tube!, Centre for Policy Studies.

to extract returns to labour or capital over and above the going competitive rate. Jobs are genuinely at risk.

Railways are quite different. They are inflexible and highly visible to politicians. Experience over decades has repeatedly demonstrated that when a rail service gets into financial difficulty then the chances are that some political authority will intervene to rescue it, whatever the cost, rather than be seen to allow the service to contract or to close. The competitive services are not usually alternative rail based but they are, ironically, bus services, the car and, increasingly in the UK, aviation services. Those who negotiate on behalf of labour know this. They sense that at the end of the day they have a direct line to the taxpayer and that they are in a strong bargaining position.

3 THE TRAIN OPERATING COMPANIES: POLICY RISK

The original concept of rail UK privatisation had at its heart the notion of open competition over the tracks, with a basic set of passenger services (many of them non-commercial) provided under competitively tendered contracts. But immediately after the Railways Act 1993 had been passed the government fundamentally changed its policy on this. A new policy entitled, Moderation of Competition was issued[13] In spite of the rail regulator's independence the government was able to impose this because, as a transitionary measure, the legislation gave him a duty to take into account any guidance given to him by the secretary of state until December 1996.[14]

Rather late in the day the Treasury had realised the implications of one of the realities of open competition. Under the old regime some of the rail routes had been highly profitable and their profits had tacitly been used to cross subsidise the loss making parts of the railway. Open competition would have annihilated those monopoly profits. Since the government had committed to not allowing privatisation to lead to any service reductions or withdrawals the implication was that direct subsidies from the exchequer would have to increase substantially. The Treasury of the day was not willing to allow this to happen. Interestingly, the removal of cross subsidy which had been enforced by restrictive licensing had been one of the explicit objectives of the bus deregulation ten years earlier. It was regarded as undemocratic and inefficient hidden taxation. The tax burden for non-commercial services was made a transparent liability for local authorities that chose to sustain them.

A further consideration was that it was doubtful whether the degree of on-rail competition envisaged in the railways white paper was even technically feasible. Foster (2005) comments that:

> "One way the 1992 white paper was misleading was in over-stating the extent of competition already judged possible. Extensive competition was introduced to the railway through franchising and outsourcing, but on-rail competition between different train companies competing on the same route was practically impossible, except in a few areas. However, differences of opinion within cabinet, and ideological prejudice, made it impossible to be open about this, a further source of confusion, since almost the only competition in this area was between participants in the policy process vying to delay admitting there could be no such competition".

John Smith has argued that there was a clear conflict between competitive franchising and encouraging the development of on-rail competition.[15] The former requires an element of monopoly - particularly where bids are based on subsidy minimisation. Hence, moderation of competition, as an interim measure - subsequently extended when the consequences of 'cherry picking' on levels of subsidy were thought through. The scope for on rail competition was also limited by capacity constraints. He recalls the case of allocating the last paths on the ECML with three contenders, GNER (extra services to Leeds), WAGN (extending services to

[13] Department of Transport (1993), Gaining Access to the Railway Network, February.
[14] Office of the Rail Regulator (1994), Competition for Railway Passenger Services, A Policy Statement, December.
[15] John Smith is an independent consultant who was previously the Head of Regulation of Railtrack: personal communication.

Doncaster) and Hull Trains. In the event, he decided in favour of the open access operator, Hull Trains. The view that large scale competition for rail passenger services is technically difficult is supported by Wolmar.[16] Jones sets out the evolution of policy towards on rail competition and presents some empirical results on the effects on fares and service quality on routes where competition exists.[17]

The rail regulator was left to implement the changed policy. This was difficult because the situation was riven with inherent contradictions: competition was supposed to be the driving force behind cost reduction, service improvement and service innovation yet competition was to be heavily moderated. In the event the regulator had to develop a horribly complicated set of rules (Office of the Rail Regulator, 1994) which were designed to allow train operating companies (TOCs) to protect what they declared as the core of their businesses whilst exposing them to competition on non-core activities. In effect one TOC could compete on fares and service quality with another in situations where there are distinct lines of route between an origin and a destination: there is more than one route between London and Birmingham because of the history of the competitive, commercial construction of the railways in the nineteenth century. In some cases this competition has been active and effective. Additionally, TOCs could trespass onto the margins of each other’s territories. Some of this has occurred, but on nothing like the scale that the original policy had envisioned.

This early change of policy was highly significant because it should have confirmed to potential investors that railways are fundamentally exposed to unpredictable policy risk - even under a Conservative administration - especially once the Treasury becomes involved. It is not at all clear that the signal was heard and understood at the time.

From 1993 the Office of Passenger Rail Franchising (OPRAF) - an agency of government under direct control - went about the business of defining 25 service groupings to be competitively tendered. Their territories were generally those of the companies that had originally constructed the railways. Train operators were to keep their revenues (and therefore to bear the revenue risks). Some passenger fares were to be regulated, though not all. Monopoly power in rail commuter markets was recognised but it was also recognised that many of the other markets were already highly competitive with road and air so price regulation was less necessary. They would bear their own operating costs, but charges for access to track and stations for the basic service patterns were to pass straight through for payment by OPRAF and therefore by the taxpayer.

The contracts specified minimum service levels: the passenger service requirement lay at the core of the franchising agreement. It comprised two components: a minimum guaranteed level of services to be provided by the operator, and a degree of flexibility above this level which allowed the operator room to develop and improve services. OPRAF specified certain mandatory service characteristics, such as train frequency, stations to be served, first and last trains, and peak train capacity. Franchise agreements allowed for adjustments of these characteristics over time, subject to consultation and a veto held by the franchising director. The franchising director hoped operators would find it in their commercial interests to offer a better service than the minimum specified in the Passenger Service Requirement. The competition was primarily over who would sign a normal commercial contract to meet the specifications for the smallest payments by government (or, in some cases, the largest

[16] Wolmar C (2001), Broken Rails, London, Aurum Press.
[17] Jones I (2001), On-rail Competition, in the Privatised Passenger Rail Industry, in Regulating Utilities: New Issues, New Solutions, Robinson C (ed), Edward Elgar.

payments to government) with the attractiveness of service improvements on offer being a second consideration.

The first contract was completed in February 1996 (South West Trains, just before Railtrack's floatation) and the last in April 1997 (Scotrail, just before the change of government). Most of the contracts had a seven year term. But five of them had a fifteen year term and were therefore due to continue until about 2012. In the case of the West Coast Main Line contract the longer term was in explicit recognition of the need to manage the major rebuilding of the route. Thirteen separate companies won contracts. Fifteen of them went to bus operators. The Virgin group, an airline operator, won the large West Coast Main Line and Cross Country contracts.

Competition for the contracts was strong and seemed to become more aggressive over time as bidders gained confidence. Some commentators at the time wondered how the companies were expecting to meet the commitments they were making. On one set of predictions, by Save Our Railways, five franchises looked like running into difficulty. But the predicted losses were relatively small and eight other franchises were expected to make big profits. It seems that, in keeping with the overall philosophy of commercial risk transfer, OPRAF on behalf of government accepted the bids at face value and did not seek to second-guess the commercial wisdom of the bidders. In many cases the bidders, especially some of the bus companies, were confident they could run the services with fewer staff. In others it was anticipated that large increases in passenger revenues could be generated by increasing both running speeds and service frequencies. Some were planning to both cut staff and increase services.

Figure 2 shows the total subsidies contracted for and the total subsides actually paid between 1997-98 and 2003-04. Had the contracts been honoured the subsidy would have fallen from £1.8bn pa to £0.7bn pa: which would have been a major triumph for the railways policy. **Figures 3** and **4** illustrate how the experience varied greatly between the different franchises. Figure 2 suggests that things went reasonably well for the first few years. Total subsidies fell only slightly less rapidly than anticipated and that was perhaps because of payments for good performance under the contracts' performance regimes. **Figure 5** shows a growth in passenger numbers from 1993 at a sustained rate which is without precedent in the last one hundred years: again, a major triumph for the railways policy.

But behind these figures there were the beginnings of problems. Quite early on some of the TOCs discovered that they had been over-ambitious in reducing employee numbers and that they could not run the service with the numbers they had planned. Service deteriorated significantly on some commuter routes into London: it was said to be the fault of 'Tory privatisation'. Secondly, trains began to impede one another. When privatisation had been designed the conventional wisdom was that the industry had been in decline for some years, there was spare capacity on the tracks and the big problem was to reduce subsidy whilst preventing further decline. The charging regime for access to the infrastructure was deliberately designed to enable new services to be offered at little incremental cost.

Figure 2: Train Operating Company total agreed bids and outturn payments (current prices)

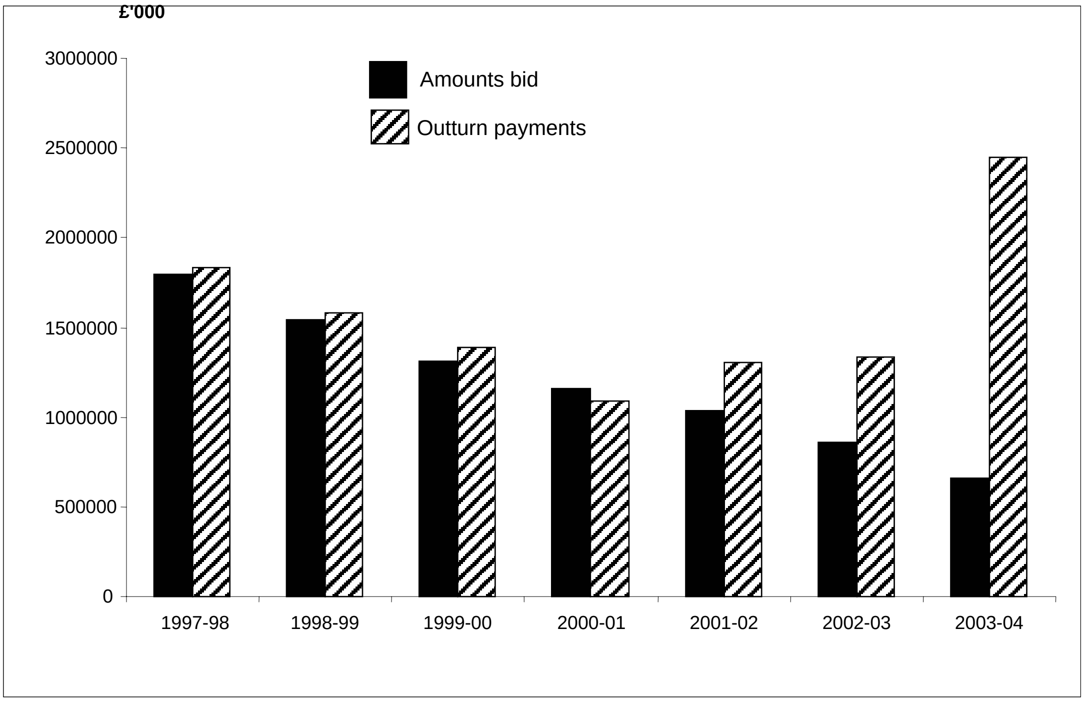


Figure 3: Virgin West Coast and Cross Country total agreed bids and outturn payments (current prices)

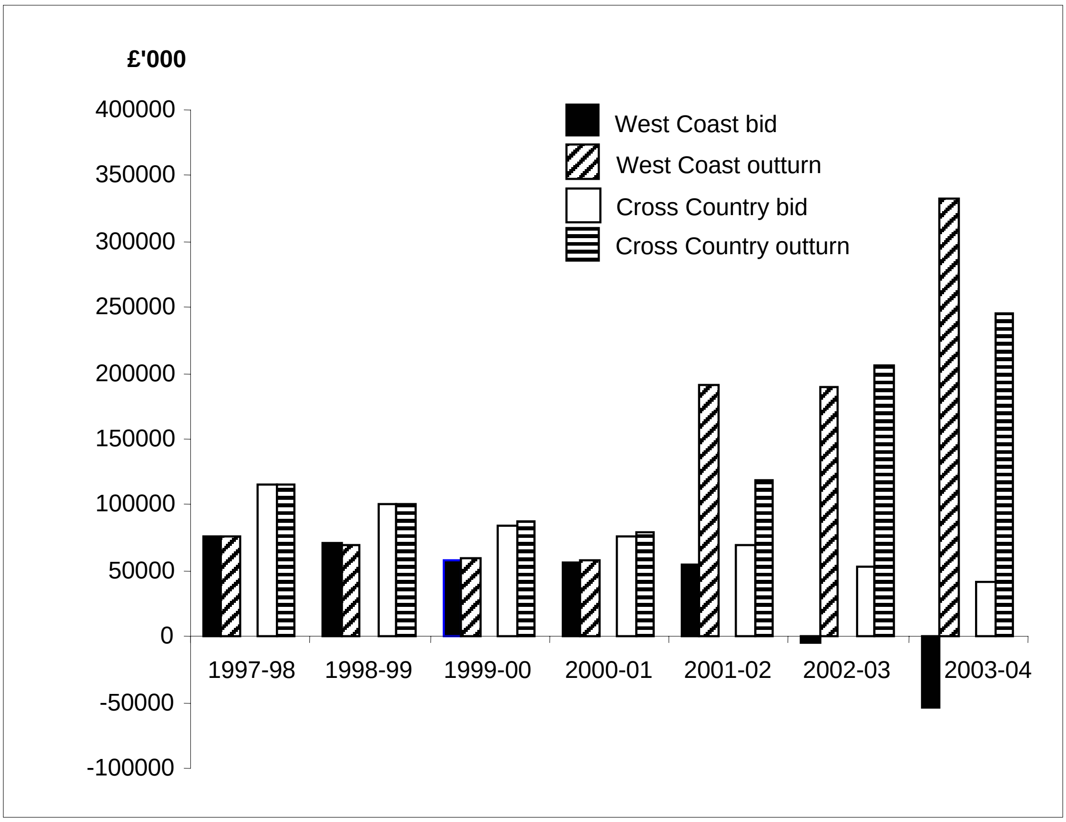
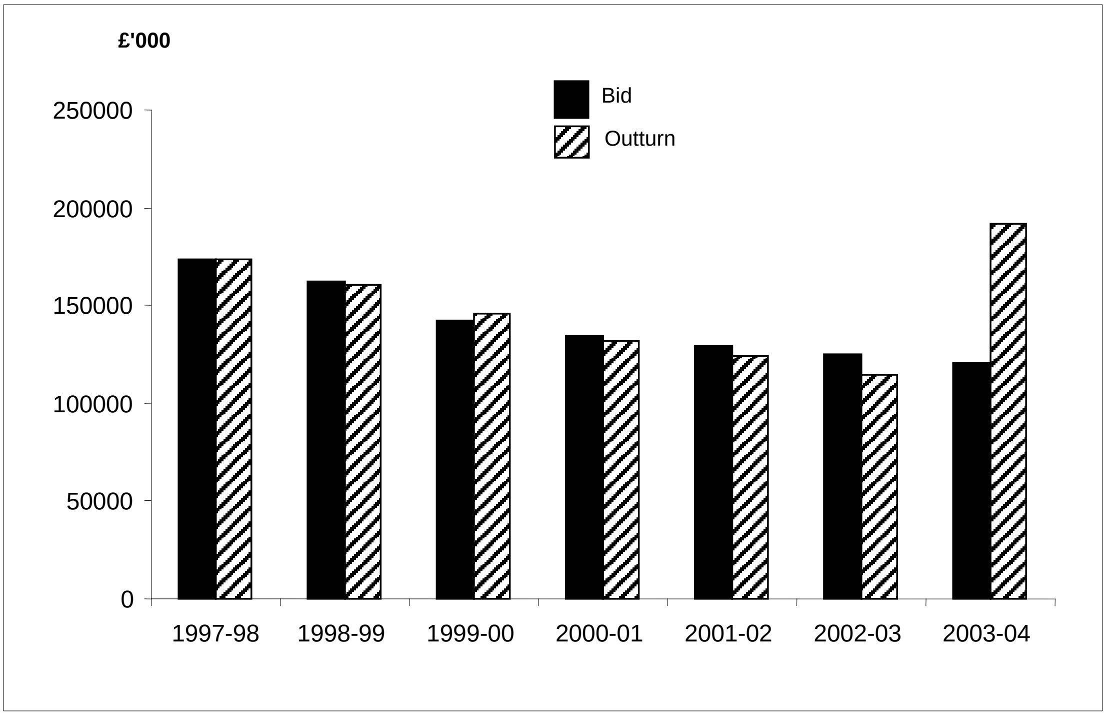


Figure 4: Central Trains total agreed bids and outturn payments (current prices)



Source for Figures 2, 3 and 4: OPRAF and SRA Annual Reports, various years.

Figure 5: Passenger kilometres - Britain 1908-2004

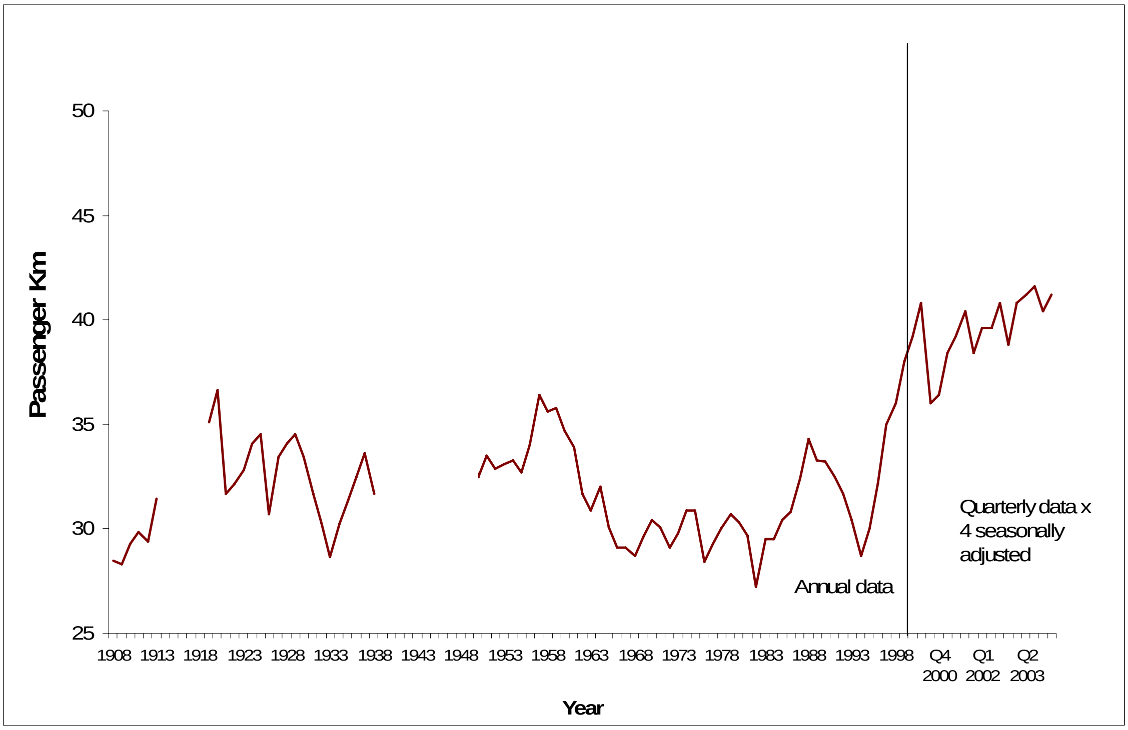
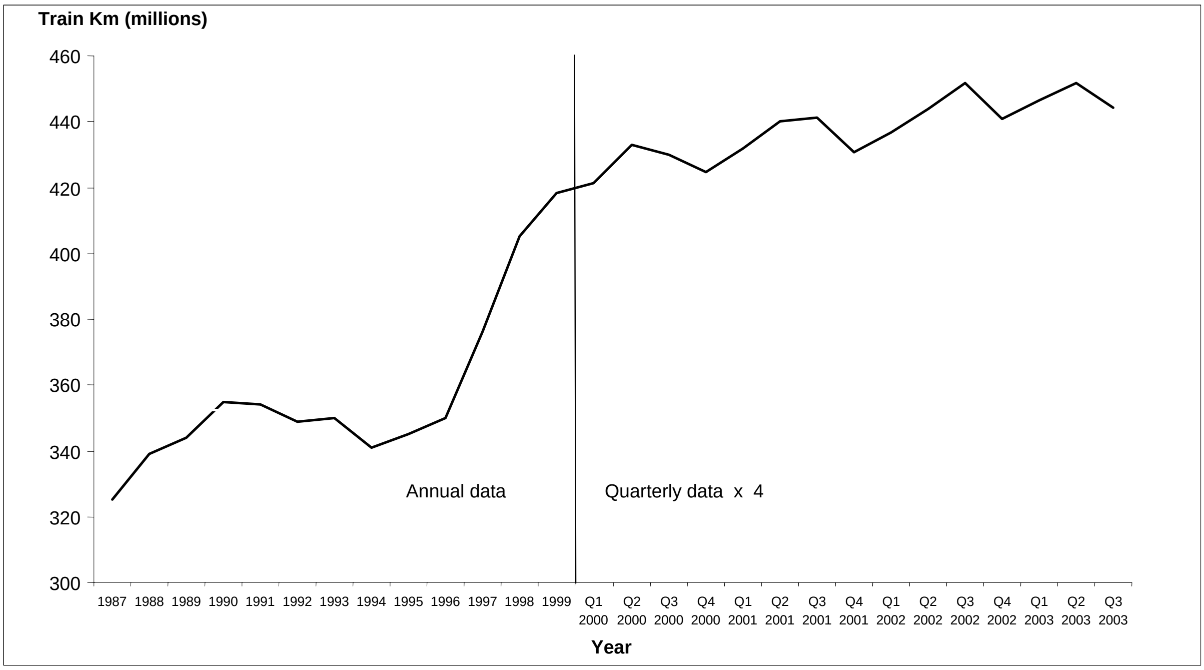


Figure 6: Railways in Britain - train kilometres 1987-2004



As **Figure 6** shows the TOCs made the intended response to the price incentive: they began to put on many more trains. Railtrack had been put in charge of allocating capacity and did not hesitate to sell as much as it could. Eventually congestion began to interfere with train reliability. This was encouraged by a deficient capacity pricing regime: Railtrack sold too many slots and the train operating companies ran too many trains because none of them had to pay for the externalities they imposed on one another. See Nombela *et al* for an analysis of a similar problem in airport investment and pricing.[18] However, one factor was that after 1997 the government was encouraging Railtrack to expand services and leading the train operating companies to believe that money would be forthcoming to expand capacity. In the event not much happened.

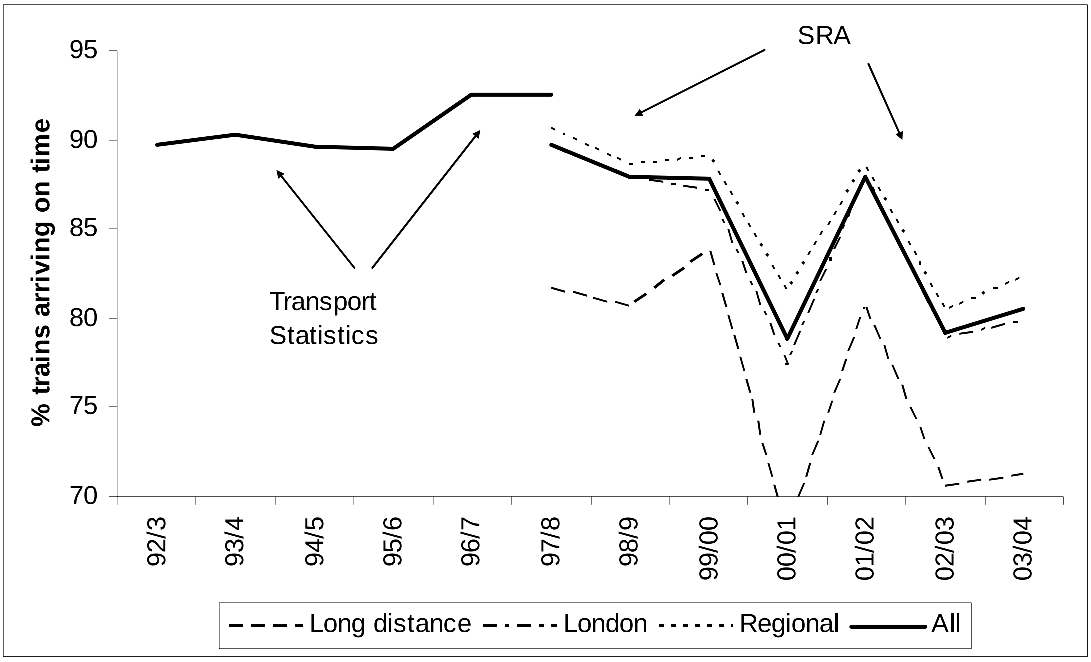
Railtrack sold as much capacity as it could because it felt it had to, but mostly it was sold below the extra cost of providing it cost. Railtrack did not profit from traffic growth - the variable component of access charges was very low in those days. Railtrack-caused delays (due to infrastructure problems) fell rapidly - by almost 40% between July 1996 and July 1999 - but train operator delays increased. As a result, total industry delays only fell by 13%. This result was partly due to more intensive services being run on the network - sometimes with inadequate turnaround times at terminals. But it was also a reflection of misaligned incentives: TOCs were primarily incentivised to grow traffic volumes (and revenues) whereas Railtrack was principally incentivised to reduce delay. Key elements in the 2000 periodic review were to give Railtrack growth incentives and make track access charges more cost reflective. Whilst the congestion phenomenon was only serious in relatively few places in 1993 there were serious problems in many of the approaches to the London termini and on commuter routes for some other major cities. These accounted for a substantial proportion of passenger trips and they are the politically salient ones. Much of the growth in passenger traffic was off peak, especially in the London area.

[18] Nombela G, de Rus G and Betancor O (2004), Airport Congestion in EU: More Investment or Better Pricing?, Utilities Policy.

In their public commentary at least the public found the declining reliability - once again, inevitably ‘the fault of Tory privatisation’ - to more than offset the benefits of more frequent and more varied services. This notwithstanding the fact that patronage continued to grow rapidly as shown in Figure 5. It is hard to obtain reliability statistics sufficiently fine-grained to document what actually happened but **Figure 7** does display a slight decline in punctuality in the late 1990s. This pales into significance when compared with what was to follow. The Hatfield accident in autumn 2001 and the subsequent delays caused by the way that Railtrack reacted to it destroyed the quality of service many of the TOCs were able to offer, as illustrated in Figure 7.

Some of the TOCs began to allege that they had run into difficulty in their negotiations with Railtrack to persuade them to provide the new, high quality infrastructure they needed if they were to achieve the revenue growth they had implicitly committed to in their contracts. The original expectation was that Railtrack would undertake enhancements on a commercial basis in return for increased track access income from train operators. It increasingly became apparent that few, if any, major upgrades were commercially viable - and required subsidy if they were to proceed (with the establishment of the SRA, initially in shadow form, responsibility for network development strategy increasingly transferred from Railtrack to the SRA). Railtrack was accused of being unresponsive and unwilling to take reasonable commercial investment risks. Ironically, while this may have had some validity, Railtrack did enter into a monumentally risky agreement with Virgin to upgrade the West Coast Main Line infrastructure beyond what had been envisaged in the original reconstruction project, in order to provide for the higher speed (140 rather than 125mph) running and the extra capacity Virgin had assumed it could achieve when it made its bid for its franchise. In the section below on Railtrack we relate how this contract was ultimately to help precipitate Railtrack’s commercial failure.

Figure 7: Passenger train punctuality 1992/93 to 2003/04



Sources: as indicated: Transport Statistics and SRA, National Rail Trends, various years

Finally, there was the change of government in May 1997 which brought to power the party that had made its distaste for rail privatisation very clear. In the first instance it decided to change nothing, perhaps because the national budgets were unusually tight, the financial position of the railway was improving rapidly and it had other problems to attend to.

However, there was a propensity on the part of the new Labour government to draw attention to failings and to promise ‘action’, rather than to take the line that the industry was now the responsibility of the private sector providers and the independent, public interest regulator, and that government should leave a mature industry to sort itself out like any other.

The perceived failings led the government to take action by replacing OPRAF with a new Strategic Rail Authority (SRA). An important transport white paper of 1998 had said surprisingly little about the railways, beyond endorsing the freight operators’ “*inspirational target*” to double traffic and noting that “*there is clearly scope for increased use of the passenger railway*” (paragraph 3.27), recognising that this would require investment in new capacity and recording that Railtrack had estimated that it would complete a solution to railway congestion problems by 2006 (paragraph 3.31).[19] But there was a firm commitment in the white paper to create a Strategic Rail Authority. This would:

> “provide a clear, coherent and strategic programme for the development of our railways... [and] will provide a focus for strategic planning of the passenger and freight railways with appropriate powers to influence the behaviour of key industry players” (paragraphs 4.12 and 4.14).

It was generally accepted that this did describe a shortcoming of the privatised rail structure. One observer has put the view that the origins of the SRA had more to do with the perceived fragmentation of the industry and the Labour government’s ‘integrated transport policy’ agenda - a concept which harked back to the 1960s. Government wanted its own agency taking the lead on network development schemes - rather than the Conservative market lead approach. In the event the relevant legislation proved to have great difficulty in finding Parliamentary time and was then delayed until the end of 2000 by controversy over the privatisation of National Air Traffic Services which was contained in the same bill. Such was the lack of determination on the part of the government that it took all of two and a half years for legislation firmly promised in the white paper to reach the statute book.

As the transport bill became ensnared in Parliamentary bureaucracy and feeling under pressure to be taking some action on railways policy, the government frequently complained about the performance of the railway. On more than one occasion John Prescott, the secretary of state for transport and deputy prime minister held railway ‘summits’ to which he summoned the leaders of the industry and insisted that something must be done. John Smith has noted that the concept of rail summits - focused on improving train performance - followed similar initiatives for the water industry, where the deputy prime minister had used summits to exhort the industry on leakage.

He spoke frequently of his intention to ‘renegotiate the contracts’ under which the TOCs were operating in order to achieve greater public accountability. It was never made clear quite what was intended by this. Ministers spoke as if they could act in the way they used to in the days of the state-owned railway, ignoring the fact that there were now fully binding commercial contracts in place enforceable in law. One of the justifications offered at the time of privatisation had been precisely that long term contracts would put the operators beyond the reach of day to day interference and would furnish the elusive long term funding that was recognised by all sides as essential if the future of the railway was going to depend upon investment from the private sector. The SRA (operating in ‘shadow’ form until it obtained its legal powers in early 2001) was instructed to commence renegotiation of the agreements.

[19] DETR (1998) A New Deal for Transport: Better for Everyone, Government’s White Paper on the Future of Transport, Cm 3950, July.

The government also exhibited a schizophrenic attitude, on the one hand wanting to engage with Railtrack on the Channel Tunnel Rail Link and, at one stage, the integration of the London underground sub-surface lines, while at the same time being willing to castigate the industry and Railtrack in particular. Talk of summits, renegotiations and the imposition of poorly thought-out new roles emphasised again the signal, still unread by many, that policy and political risk were a serious problems for private sector involvement in the railway.

Not surprisingly the progress of negotiating changes proved slow. No contracts changed during the first Labour government. Agreement was reached that one franchise would terminate and change hands before the contract reached full term. Meanwhile, in late 2001 it began to transpire that several train operating companies were in serious financial difficulty and had been rescued from the prospect of company failure by subvention from government: in some cases creating what amounted to a ‘cost plus’ procurement arrangement. This shows up in Figure 2 where, for the first time contract payments for 2001-02 are significantly above what had been specified in the agreed contracts.

There are several possible explanations for the decline in the financial position of the TOCs. As Figure 1 shows the average hourly rates of pay for railway staff in general and particularly for train drivers were rising rapidly ahead of inflation. **Table 1** shows that the numbers employed by the TOCs had fallen markedly between 1996 and 1999.[20] They then increased but probably less rapidly than the volume of train service provided.

Table 1: Numbers employed by the train operating companies

£000s	1996	1997	1998	1999	2000	2001
Number employed	46,845	44,577	37,108	36,392	37,095	38,234

Source: Shaoul (2004)

So it is likely that improvements in productivity offset the increasing pay rates to some degree. In 1992-93 the industry had 138,000 workers but only 1,500 part-timers. Work patterns were inflexible in an industry which is subject to great peaks in demand. There were few split shifts. New Labour contracts quickly emerged. Great Western’s train drivers had a guaranteed salary of £20,200 in place of a basic wage of £11,700 plus many allowances. They had a shorter working week, more rest days and holidays. Drivers drive single-manned up to 125mph instead of 100mph. On the Midland Main Line National Express cut the workforce by 23% and on Gatwick express by 17%. Compagnie Generale d’Entreprises Automobiles (CGEA) imported more flexible working practices from rural French lines into Network South Eastern and South Central. In July 1997 National Express made an offer to 800 Scotrail drivers which would increase their average earnings by 23% to £21,500 and cut their basic working week from 39 to 37 hours per week. The new management was reported as hoping to finance the improvement by reducing administration costs. However, if the TOCs had hoped for the competitive reduction in pay rates that they had enjoyed with bus deregulation (many of the parent companies are large, established bus operators) then they would have been disappointed and would not have achieved the unit cost reduction they had budgeted for.

The experience varied greatly across the TOCs. In the case of the West Coast Main Line, the Virgin airline group committed to turning a subsidy of £77m in the first year to a small

[20] Shaoul J (2004), Railpolitik: The Financial Realities of Operating Britain’s National Railways, Public Money and Management, January.

payment (ie, a negative subsidy) by 2002-03 and a payment of over £200m a year by 2008-2009. Similarly, their winning Cross Country bid was to convert a subsidy of £12m pa into a payment of £10m pa by the end of the 15 year term. These were ambitious and, if taken at face value, attractive promises. But, as Figure 3 illustrates the two Virgin franchises began to receive extra payments in 2001-02. In any case, it seems likely that these bids were always over-optimistic and both had already run into serious difficulties with the level of service they were able to secure from Railtrack. In later years the discrepancies became much larger. Alistair Osborne gives a good account of the West Coast Main Line debacle (Daily Telegraph, 25 September 2004):

> "With typical razzmatazz, Branson said he would order 140mph trains, capable of tilting round corners, so enabling them to negotiate the bendy west coast route faster. The London-Manchester trip would come down to 1 hour and 45 minutes, roughly an hour quicker; London-Glasgow would be less than four hours. The trains, supplied by Alstom, would cost £1.2bn, including a £600m maintenance contract.
>
> Believing he could see off the airlines, Branson made a big bet. He signed up for a franchise running until 2013, receiving a total £460m of subsidy until 2002. After that, he would start paying the taxpayer to run it. Over the rest of the franchise, he undertook to repay almost £1.4bn, with annual payments rising in the final year to £248m. For this, Branson needed a guarantee from Railtrack that it could provide the high-speed line for his Pendolino service. Railtrack calculated 140mph running would add £600m to the west coast upgrade, raising the total to £2.1bn. In exchange, Railtrack negotiated a revenue share… The contract contained a clause compelling Railtrack to pay Virgin £250m compensation should it fail to deliver the railway - a vast sum for a company floated with less than £2bn of equity. In December 1999, Railtrack admitted that moving block technology, as proved on the Jubilee Line extension, simply didn't work…
>
> Says Chris Green, the Virgin Trains chief executive who steps up to chairman on Monday: "Had Railtrack waited and got a proper technical report, they would have found out moving block was not the answer and that the costs were going to be massively more than they thought". Railtrack's realisation set in train a sequence of events which have proved ruinously expensive for the taxpayer. As Railtrack belatedly got to grips with the west coast project, the forecast cost rocketed - to £5.8bn in 1999, and £7bn in 2001. Upgrading one of the world's busiest rail networks, used by 14 other operators apart from Virgin, was "like trying to rebuild the M6 at rush hour - but without a contraflow", Railtrack complained.
>
> Long aware of the risks, Branson showed typical acumen in June 1998, selling bus and rail group Stagecoach a 49% stake in Virgin Trains. Two years later, he renegotiated the franchise, legitimately arguing that while he had committed himself to the trains, the upgrade was in disarray. The negotiations continue to this day… Meantime, Virgin runs the franchise as a management contract, making a small profit margin. In the year to March 31, 2003, when the original franchise agreement envisaged a £4m return to the taxpayer, Virgin received £189m. In the most recent financial year, Virgin got £332m instead of paying back £59m, with subsidy per passenger for each mile travelled almost doubling to 20p".

Figure 4 shows that Central Trains kept to its bids until the effect of the increased access charges was felt in the final year (for which the TOCs were not accountable). By July 2003 nine of the franchises had failed financially and had been allowed to continue on some kind of cost plus basis.[21] A crucial policy decision had been taken that the normal mechanism for enforcing commercial risk transfer, namely bankruptcy, was not going to be enforced.

The Transport Select Committee commented adversely on this (2004, paragraphs 119 and 122):

> "… it is clear that the vast majority [of franchises] have not been able to produce the efficiency gains that were confidently anticipated at the time of privatisation. The network is now being run by a patchwork of companies, which operate with a variety of incentives…
>
> In our view, the essence of private sector involvement is that the private sector pays if it gets its sums wrong. It is outrageous that such astonishingly large sums of taxpayers' money have been used to prop up palpably failing businesses…".

The legislation made provision for special arrangements in order to keep services to the public going in the event of bankruptcy of a train operator. Even so, it is possible that some of the bidders correctly anticipated that government would not, in practice, be able to stomach bankruptcy of a public passenger rail service should things go badly. The consequence could have been over-aggressive bidding in order to secure the contract in the first place.

It is also possible that some of the TOCs were victims of the 'winner's curse'. This can occur in auctions where there is uncertainty about the future value of the item being bid for and there is a random element in the value each bidder estimates. Some will be too high by chance and some will be too low. The bidder who has the misfortune to have the highest estimate of the value will be the one that wins the auction and will therefore pay too much; unless bidders are sophisticated enough to anticipate the problem and shade their bids accordingly.

There has been one more twist in the story of the competitive provision of passenger services. The SRA came under particular pressure because of the poor performance of commuter services operated by Connex from the south east suburbs of London. Rather than engineer some other private train operator to take the service over the SRA took over the operation itself. Thus SE Trains is now directly owned and operated by the public sector.

Over the years the SRA struggled with the issue of how long franchise contracts with the TOCs should be. As the London buses experience illustrates short contracts favour the commercial discipline that goes with active competition for contracts. But at one stage the SRA seemed to be convinced of the view that because of the need to secure long term investment, it is advantageous to agree long tenures for the rail contracts.

As chairman, Sir Alistair Morton perceived a need for large scale investment in expanding the capacity of the network to meet government growth targets. He believed that Railtrack had neither a big enough balance sheet nor the programme management skills to undertake the necessary investment – hence the need to encourage investment by the TOCs. This was to be facilitated by long term franchises: twenty or thirty years were favoured at one time. The

[21] Transport Select Committee (2004), The Future of the Railway, paragraph 123, HC145, March.

SRA encouraged the TOCs to come up with their own ideas for network enhancement which led to a range of propositions including a new high speed East Coast Main Line between Peterborough and York and proposals for re-siting Clapham Junction. It was ironic that the administration that was so frustrated by their inability to alter the seven year contracts it inherited was so determined to commit to contracts as long as twenty years (and thirty years in the case of the London underground infrastructure contracts). Few new franchises were actually let.

The government eventually over-ruled the SRA and insisted that, at least for a while, only short term extensions to agreements were agreed - and, note that these were not competed for. Extending contracts, rather than recompeting them, obviously upsets the incentives hoped for from competition for the market. The Transport Select Committee concluded that (2004, paragraph 124) "*Existing franchise agreements should be extended only if there are compelling operational requirements, or clear value for money justification. Extensions are a measure of last, not first, resort…*".

The rolling stock companies

In order to keep barriers to entry to the train operating business low, the structure at privatisation created three companies (ROSCOs) to own, lease out and to invest in new passenger rolling stock. They were, and remain unregulated. It is unclear to what extent these companies competed amongst themselves: there are important technical restrictions on the transfer of rolling stock between different lines. However, it was always open to TOCs to procure rolling stock in other ways and several (including Virgin) have purchased their own - which put its own competitive pressure on the ROSCOs.

At various times complaints have been made to the effect that the ROSCOs were earning excessive returns (see for example, Shaoul, 2004) and the companies were sold on for much more than they had initially been sold at privatisation. The rail regulator investigated the ROSCOs under his competition powers and the National Audit Office (NAO) investigated the original sale. In neither case was any major problem discovered, though the companies agreed a code of practice with the regulator.

However, in spite of this being an area of the railway that seems to have functioned through competition without great difficulty, the government is now determined to intervene. In the July 2004 white paper, The Future of Rail (paragraph 4.3.30) says that "*…the markets in rolling stock financing and maintenance established at privatisation are not working in the way they were expected to, and … there is a case for looking to see how the operation of those markets can be improved…. the government will develop a longer-term strategy for the rolling stock market, which will help the industry to plan ahead more effectively*". According to The Guardian (16 July 2004) "*Mr Darling is understood to be considering ordering an investigation into the three companies by the competition authorities. There have been calls from some rail industry figures for the industry to face tough statutory regulation*".

Rail freight

Before privatisation it had been policy for a number of years that rail freight services should at least cover their allocated costs - though that had not always been achieved in practice. Freight services on the privatised railway were always intended to be entirely by open access, competitive companies. That is, there was no attempt to create any analogous arrangement to the subsidised passenger rail franchises.

The first intention had been to offer the existing freight business for sale as a number of companies. However, having tested the market only two companies were created. There has since been significant competitive entry by other carriers. Access charges for freight were set to cover rather modest estimates of variable cost alone, in order to maximise the chances of viable rail freight developing, and on the argument that much rail infrastructure is maintained primarily for the benefit of passenger services. This strategy proved to have two failings. First, as the volume of heavy freight usage increased it became apparent that the cost of track wear and tear from freight was significantly higher than had been assumed. An industry insider comments that:

> “the real problem was the nature of the access agreement with EWS which allowed freight to roam across the network. New flows - such as coal traffic from Hunterston to power stations in Yorkshire and the Midlands brought heavy coal trains onto the Carlisle and Settle line, which for 20 years had been maintained only for light passenger trains, and gave rise to a bill of more than £100m for track repairs – ultimately paid for by the taxpayer. Freight flows, unlike passenger, can be relatively short term”.[22]

Secondly, as track became congested the failure to price in long run capacity costs meant that rationing had to be enforced and the price signals were not capable of bringing about efficient use of the network.

Not withstanding these weaknesses it seems that competition for rail freight services has worked reasonably well. There has been significant innovation in both the nature of the services offered and in the methods used to deliver them. For instance, the freight operators were able to purchase a quantity of cheap and reliable locomotives from General Motors of America, something that had not happened under nationalisation.

Rail freight has not all been a success story. The loss in 2004 by the rail freight operator of the contract to run special mail trains was attributable, in large measure, to concerns over service reliability. If rail freight did not grow as fast as it would have had to have done in order to meet the government’s (unrealistic) target of 80% growth above 2000 levels, it was because of a fundamental weakness in the rail freight markets. However, such growth as there has been has largely been in traditional sectors (eg, moving coal to power stations over longer distances) - there has been less success in winning new markets.

Julia Clarke, who was Executive Director, Freight, at the SRA expressed the view that competition in rail freight has been a successful policy. She states that the UK rail freight industry:

- “has increased its carryings by 50% over the past 10 years, reversing four decades of decline;
- has invested over £1.5bn in new equipment, facilities and systems;
- has significantly improved its performance, productivity, efficiency and customer service;

[22] Personal communication.

- is no longer protected from on-rail competition and offers customers genuine choice of operator and approach;
- is a mature industry engaged in constructive debate about industry issues;
- offers a product which is easier to understand and more transparent in its costing, hence giving greater confidence to its customers”. [23]

She concludes that “*the success of rail freight points to harnessing market forces and creating appropriate incentives rather than regulatory or structural change as the way to improve performance*”.

[23] Clarke J (2004), Making Markets Work in Rail Freight, The Transport Economist, Spring.

4 RAILTRACK AND NETWORK RAIL

The failure of Railtrack is the best known of the difficulties experienced by the UK rail privatisation. In fact, the policy would have run into difficulty in any case because of the severe problems experienced by the TOCs, unrealistic political aspirations and inadequate funding to meet them. But Railtrack attracted by far the greatest public attention. Recovering from its demise continues to this day to be extremely difficult.

Railtrack was originally set up as an ‘ordinary’, shareholder company with ownership of the fixed physical assets necessary to run the railway, subject to company law and specialist, independent regulation. Its principal source of income was the charges it received from its customers, the TOCs and open access passenger and freight operators. Apart from some specific freight facilities grants there was to be no direct subsidy.

This was designed to create transparency and the normal commercial incentives to be efficient and to seek out commercially viable enhancements. Crucially, Railtrack was deliberately put beyond the direct control of government, on the grounds that experience had repeatedly shown that government interference has been damaging to the successful running of rail businesses. Being an ‘essential facility’ and a monopolist it was subject to public interest regulation but the rail regulator is independent of government and answerable only to the courts for his interpretation and administration of the legislation. Therefore the overall concept was that Railtrack, like any other large private infrastructure company would be disciplined in the first instance through its accountability to its shareholders whose personal equity was at stake, and ultimately by the market for corporate control.

For the first time since nationalisation in 1947, privatisation and the regulatory regime created an economically meaningful capital finance regime for Railtrack. British Rail, for much of its existence, had no equity and had been obliged to carry a burden of debt that represented the consequences of long-past events but gave no meaningful guide as to sensible economic decisions looking forward. Under the new regime Railtrack had a conventional debt and equity structure. The charges set by the rail regulator were appropriate to remunerate both existing activities (including a return on investment and charges to repair and maintain the physical assets) and any approved enhancements.

At first things certainly seemed to go well. The shares were over-subscribed at flotation at a price of £3.90. That valued the company at £1.9bn, less than half the historic cost book value of the assets. The share price reached a peak of £17.68 in 1998, after the change of government: the financial analysts were clearly unconcerned by the clearest possible signals that policy and political risks were lurking in the background. They must have perceived a relatively low risk public utility with the potential to expand its capital base and to increase and preserve profits.

The conventional wisdom of the early 1990s was that British railways had always been dominated by engineers who were unable or unwilling to respond to the pressures to make the railway sufficiently efficient and modest in scale for it to be affordable in modern economic circumstances. The evidence is that, whilst this may have been true at various times in the past, the revolution of the nationalised industry under the leadership of Sir Robert Reid (himself a career railwayman; chief executive and then chairman, 1983-1990) was quite remarkable by international standards.

Robert Horton, the first chairman of Railtrack, and, from 1997, Gerald Corbett, a powerful chief executive, were both recruited from other industries. It is alleged that many of the best senior engineers were lost to the company during the restructuring of the industry in the mid 1990s, other managerial skills being preferred over theirs (see for example National Audit Office, 2004a, paragraph 2). All this may have contributed towards a tendency to underestimate the extreme complexity of a large railway system, having heavy, long-lived, safety-critical assets of many types, all working together in a heavily inter-dependent system. If one asset fails a significant part of the system will often fail.

There was another problem which, in the long run, turned out to be just as significant. The senior management of Railtrack, many of whose previous experience had been in unregulated industries seemed to find difficulty with the special public service and public accountability dimensions of their new industry. The rail regulator was regarded as an adversary. His legitimate function in representing the public interest, those of Railtrack's users and ultimately those of taxpayers who were liable for the Railtrack's charges was not understood. It was wrongly assumed that the long term interests of shareholders would be best served by keeping the rail regulator as far away from the company's affairs as possible: anything seen as an intervention was resented; information was not supplied willingly. Both economic and safely regulation were resented as being intrusive.

John Smith has pointed out that there were other sources of difficulty in the relationship between the regulator and Railtrack. First, the peculiar nature of the regulatory regime with its contractual focus, and regulatory approvals for track access agreements.[24] John Smith argues that the Office of the Rail Regulator lacked a clear model of rail regulation. The initial focus was on the contractual regime and it is no accident that both the rail regulators were lawyers. The original belief appears to have been that, rather like the LUL PPP, that improved performance would be driven by the S.8 performance regime - this would provide the necessary incentives to address the causes of train delays and minimise infrastructure failures (and also to be carried through into the behaviour of contractors). Railtrack saw its key role as reducing infrastructure-related delays and achieved a 40% reduction over the first 4 years. There was no other 'regulatory contract' with defined outputs as was normal in other regulated sectors. With the arrival of the New Labour government, attempts were made in 1997 to strengthen the licence framework, notably with Condition 7, with obligations to meet the 'reasonable requirements' of customers and funders and produce an annual Network Management Statement. On the back of condition 7 some output targets were specified in 1998 - including a performance target for reducing train delays, although this cut across the Schedule 8 incentive regime. In John Smith's view it was not until the outcome of the 2000 periodic review that a proper economic framework of regulation was put in place - including a basis for remunerating network enhancement, and an output-based regulatory contract.

An early incident, which was to prove a main cause of the commercial failure of Railtrack, was the negotiation of a contract with Virgin for the upgrading of the West Coast Main Line to accommodate higher running speeds than had been envisaged at privatisation. The terms of the contract had to be approved by the regulator. He duly approved the contract: even though he may have had doubts about whether the project could be delivered at the agreed price he took the view that Railtrack's shareholders would bear the commercial risks of the project and should be left to do so. However, he did make his approval conditional on Railtrack creating major increases in the capacity beyond their proposals in order to cater for the legitimate needs of freight and other track users who had been rather forgotten in the rush to cater for Virgin's requirements.

[24] Personal communication.

As we have noted in the section on the train operating companies, it later transpired that Railtrack had committed to this commercial contract on the basis of inadequate understanding of the condition of the infrastructure leading to optimistic engineering costings, and on an imprudent view of the ease with which a modern (and untested) electronic signalling system could be used. It is said that amongst the main causes of the huge cost overrun were frequent changes of specification as more train operating companies and more freight operators were given access, too many changes of project manager, and the unwillingness of Virgin to wait for satellite signalling to live up to its promises. Allegedly, the most damaging re-specification came out of the blue from the European Union which demanded the new signalling met their new standards. In the event it took ten years to do so. Otherwise the West Coast Main Line might have been ready within the estimated time or shortly after.

It is hard to believe that a prudent company would have committed itself to such a large engineering project on the basis of improperly quantified risks, had they not implicitly been assuming that if things should go wrong then the government would come to the rescue, as they had so often under the old regime and, indeed, as they subsequently did for a limited period.

A second matter of significance was a familiar one for regulated private utilities. The regulated access charges were set on the basis that they would be sufficient to pay for adequate maintenance and renewals work and to pay a proper return on equity and debt. The accusation was made that Railtrack was spending too little on maintenance and renewals and too much on dividends to shareholders: one of the reasons for the rise in share price. The frequency of equipment failures, including the incidence of broken rails, gave credence to this view. Even though Railtrack did achieve higher rates of investment in their infrastructure than had been achieved before, the National Audit Office (NAO, 2000, Figure 2) confirmed the view that there had been a decline in some aspects of the health of the network and, in particular an increase in the number of broken rails, an important railway health indicator. The regulator had become concerned that the network was not being adequately maintained and, specifically, had warned that the increase in the number of broken rails was not acceptable. Arguably, the decline in track quality and increase in broken rails were mainly the consequence of traffic growth on the system. Ironically, the number of broken rails was falling by the time of Hatfield. The government promised action, but did very little beyond holding a few conferences at which ministers berated the industry and told it to improve.

The regulator intervened to modify Railtrack’s licence, with their agreement, in the attempt to ensure the meeting of demanding new targets. Poor reliability was attributable to performance failures by both train operators and Railtrack. On performance, Railtrack was successful in reducing train delays up to 1999/00. Indeed it achieved a 10% reduction in that year - the best ever performance - but was fined by the regulator for failing to meet his target of nearly 13% reduction. However, the principal problem was misaligned incentives - Railtrack having much stronger incentives to improve performance than TOCs who were more incentivised for growth.

Thirdly, the regulator was concerned about the inadequacy of Railtrack’s knowledge of the volume and condition of its assets. Before privatisation British Rail had full data on paper, separately on each class of asset and kept locally all over the country. But this stayed with the several British Rail engineering companies when they were sold to the private sector and Railtrack had difficulty extracting any information from them, let alone enough to create a comprehensive, central asset register. This had been a problem for the government in setting the initial access charges. It is impossible to know how much should be spent each year to bring the assets up to a decent standard and to maintain them unless there are good, readily accessible records of current quantum and condition. The regulator recognised his need for better asset information in order to be able to set access charges in the future. Although one would have thought that Railtrack would need this information for their own internal purposes in order to be able to husband the assets for the long term financial benefit of the shareholders it seems that they were slow to overcome their difficulties and create an adequate asset register. The regulator insisted that this be done and complained that Railtrack persisted in being inadequately active on the matter.

One should not underestimate the size of this task. There are some 700 asset categories for the railway reflecting a whole range of technologies. To be effective the register has to be tied into a work management system so that the register is continuously updated with activity undertaken on the network. Hence, the contractors had a key role in operating the system. Few continental railways have yet succeeded in developing such systems.

Finally there were two major accidents, both in West London, one in 1997 at Southall which seven people were killed and one in 1999 at Ladbroke Grove in which thirty one people were killed. Both accidents involved trains failing to stop at red signals. The extent to which privatisation may have been a factor remains controversial but the general public, encouraged by ministers immediately laid the blame at the door, once again, of 'Tory privatisation'. Rightly or wrongly, Railtrack were very heavily criticised in the press after the Ladbroke Grove accident. Senior members of the government seemed to take short term advantage of this, joining in the criticism and promising that they would discipline Railtrack to force it to become absolutely safe, whatever the cost.

This was a crucial turning point: government could have taken the line that this was now a private industry and it was a matter for the independent safety and economic regulators to sort out. Government routinely takes this line, for instance, in the cases of aviation and gas accidents. This very public intervention by ministers greatly heightened the general public's perception that privatisation had made the railways less safe. To this day there is a strong public perception that the railway has become less safe since it was privatised. However, the evidence is clear that safety was improving before privatisation and it continued to improve at much the same rate afterwards.[25]

All these factors came into play after another accident at Hatfield in October 2000. A train travelling at speed was derailed because of the failure of a decaying rail. Four people were killed. On investigation it was quickly established that the rail in question had exhibited symptomatic cracks before failure.

The accident was most unfortunate and may have been a consequence of avoidable negligence, but it was not as serious as some railway accidents and it did not take the accident rate outside what was to be expected on the basis of historical trends. However, the way Railtrack responded to it did immense damage to the industry (Foster and Castles, 2004). Because of their experience after Ladbroke Grove they feared the worst possible response from the press and from government. Therefore, they felt they had to avoid another accident from a similar cause at all costs. Management jumped to the conclusion that cracks might exist at many other places on the system and cause a similar catastrophic failure. It was later established that, whilst the phenomenon of gauge corner cracking did indeed exist in many parts of the network, there were no problems comparable to that responsible for the Hatfield

[25] For a definitive analysis see Evans A (2004), Rail Safety and Rail Privatisation in Britain, Inaugural Lecture of Imperial College London.

crash and none that could not have been handled in the ordinary way. The episode highlighted that with the new privatised railway no-one was responsible for managing the critical wheel/rail interface and that the cracking phenomenon was attributable in large part to changing wheel profiles.

Consequently Railtrack all but closed the system: they imposed very wide and restrictive train speed limits and caused many train cancellations. Experienced railwaymen have said that they would not have reacted in this way and senior management received advice against the need to do it. It destroyed the train service and the businesses of the train operators. The disruption was compounded by one of the wettest autumns of recent years leading to embankment slips and flooding which added materially to the service disruption.

All this lead to the catastrophic decline in passengers displayed in Figure 5. Naturally, Railtrack lost income through failing to provide contracted train paths to its customers, the train operating companies, and it suffered financial penalties under the performance regime.

The chief executive of Railtrack at the time of the Hatfield accident gave his own account when, in September 2004, charges under the Health and Safety at Work Act were eventually dropped (Daily Telegraph, 3 September 2004). Gerald Corbett, 52, said constant interference by the government had made his job impossible:

> "Labour had always been opposed to rail privatisation and, when they came to power, it was almost as if they were willing the privatised railway to fail," he said. Mr Corbett said that after the Ladbroke Grove rail crash in October 1999, which killed 31 people, Railtrack endured constant jibes from the government that it was "putting profits before safety"…."But the context in which we were operating was one where we had no political support. After Ladbroke Grove, John Prescott [the then Transport Secretary] made sure nothing would stick to him. He said he was putting in inspectors to review our safety with the spin that we were being stripped of responsibility for safety".
>
> The Health & Safety Executive undertook a three-month review of Railtrack and "concluded that our safety procedures were in good order", Mr Corbett said. However, by then serious damage had been done to the company's reputation, resulting in Railtrack's panicked reaction to the Hatfield crash in October 2000. He said the crash, which killed four, highlighted "two main problems. First, the way the railways were privatised. It was done the wrong way - the fragmentation, the tying it all together with adversarial contracts, the splitting it up into 100 pieces. It made it a managerial nightmare. When you couple that with the political interference you faced in the railway, it was almost mission impossible".

Foster (2005) has remarked that "*broken rails elsewhere have never been a major cause of accidents. Like Southall, and Ladbroke Grove, Hatfield was caused by human error. What went wrong at Hatfield, and was subsequently put right, was a serious management systems failure*".

Under pressure from government Railtrack embarked on a hopelessly ambitious and expensive programme of emergency track replacement. At first they promised government and the public that the work would be complete in time for Easter 2002 - presumably because they thought that was what government wanted to hear - even though the simplest calculations of the volume of work and the labour and materials available to do it showed that this deadline could never have been met.

Coincidentally the regulator's periodic review of Railtrack's charges was published just after the Hatfield accident. It had been in preparation for many months. During the proceedings for the periodic review it became clear that Railtrack was facing a second, major financial problem because of the commercial agreement concerning the West Coast Main Line. Railtrack had seriously underestimated the cost to them of meeting the commitment they had made.

Government had already made substantial special grants available direct to Railtrack to rescue it. The situation, as it was known at the time, was taken into account in the Review. However, in the months following its publication Railtrack's finances deteriorated as a result of the Hatfield accident and steady increases in the costs of the West Coast Main Line. A deal between Railtrack and the government and SRA was agreed in April. This involved bringing forward revenues which, as part of the periodic review, had been deferred until 2005. There was also a statement of principles, agreed with government, which redefined Railtrack's role in relation to the network - for example, re-focussing on stewardship of the existing network and making enhancements 'contestable'. The agreement endorsed Railtrack's role as the national infrastructure provider but the company acknowledged that responsibility for funding and delivery of major enhancement schemes could rest with other companies or consortia. Future enhancement projects were subject to competitive procurement - a new competitive dimension.

That seemed to stabilise the situation for a while and the Treasury started to pay, further direct grants. However, a new Railtrack chairman was then appointed and he was intent on new negotiations - and perhaps lacking in knowledge of what went before. The independent rail regulator has said that Railtrack made a mistake in attempting to negotiate privately with the government for yet more grant, rather than making a proper application to him (Winsor 2004a).[26] He would have been bound to consider it seriously under one of his primary duties in the Railways Act 1993: to enable Railtrack to finance its activities.

In October 2001, without warning, the secretary of state for transport (Stephen Byers) took the opportunity this presented to him. He invoked the special provisions of the Railways Act to put Railtrack into railway administration. This made the shares worthless and the secretary of state stated that there would be no compensation for the shareholders - although some months later the pressure from the City institutions was sufficient to cause a policy reversal on this and the government found a way effectively to increase Railtrack's borrowings in order to pay approximately £2.50 per share as compensation to the shareholders, a little less than the share price on the day before the weekend on which the administration was announced. Debts to bond holders are to be honoured.

It would have been an option to have encouraged a conventional take over of Railtrack and there were companies that showed an interested in this. The normal competitive market for corporate control would have acted to change the management and rebuild the company. That would have kept the structure intact and avoided the damaging hiatus that, in fact, occurred. However, it seems that Stephen Byers was determined to take the opportunity to destroy the privatised, shareholder ownership structure that the Labour government had inherited in 1997, thereby fulfilling one of the promises made by Claire Short in the privatisation

[26] Winsor T (2004b), 2004 DfT Rail Review - Submission by the Rail Regulator, Office of the Rail Regulator, 6 May.

prospectus. It may have been seen as a fortuitous opportunity to achieve what Labour had promised. This was probably the most overt and aggressive manifestation of political risk since rail privatisation. The secretary of state indicated to the regulator that if he should seek to exercise his independence by considering a request from Railtrack for an increase in its charges and thereby save the privately owned company then the government would immediately introduce summary legislation to overrule him (Winsor, 2004a, b).

This compromising of the regulator's independence is of considerable significance, not only for the future of the railways, but also for the other UK privatised utilities. At the time the government appeared to forget that one of the most important functions of the regulators is to stand as guardian of the interests of private investors so as to ensure they receive a reasonable rate of return providing the company acts in an economic and efficient manner. This provides a vital protection against the kind of policy risk that the past experience with the railways illustrates so clearly.

If the left of the Labour party had seen this as the opportunity to completely renationalise the railway, they were to be quickly disappointed. The Treasury were unwilling to find the funds necessary to buy out the TOCs' contracts and other surviving private interests. In addition and more importantly, Railtrack had considerable and rapidly increasing debt which had been classified Office of National Statistics as private debt on the grounds that the company was under private, not public, control. The Chancellor was absolutely unwilling to countenance any move such as renationalisation that would bring that debt onto the public balance sheet. This is a consideration that remains central to railways policy to this day.

Railtrack lingered in administration for about a year. This was at considerable cost, one estimate being as much as £14bn (Winsor, Spectator, 3 July 2004; this may be an over-estimate: the NAO, 2004a discuss this issue at paragraph 3.13). But more importantly the industry was becalmed pending a satisfactory resolution for its long term future. When the government eventually made a proposal acceptable to the administrator, Network Rail was allowed to take over Railtrack's assets. There was no active competition for the right to do this: there had been two other potential bidders but they withdrew, one of them stating that "*they were discouraged by the government's stated preference for a 'not for commercial return' non-share company, and also because such a company had already been launched with government financial backing*" (NAO, 2004a, paragraph 1.18). It is apparent that the government already had a clear idea of how it wished to proceed and did not see value in conducting a market competition to establish the best terms under which a new corporation could be founded.

Network Rail

At the point of putting Railtrack into administration the government announced that it wished to replace the existing Railtrack by a non-equity based company - in this case a company limited by guarantee. This would be run by an executive accountable to about one hundred and twenty 'members', each chosen to represent one of a large number of public and private interests including train operators, railway employees and passengers. It was described as 'not for profit', thus appearing to deal with the objection to the earning of profit in a public utility. The company would be entirely financed by debt.

In choosing this preferred model the government was greatly influenced by Glas Cymru, a relatively small and simple Welsh water company that had been set up as company limited by guarantee in 2001.[27] On close inspection it is apparent that these companies are in fact ‘not for dividend’ as distinct from ‘not for profit’ as was made clear in the Department for Transport’s notices to the press at the time. There are no conventional shareholders but profit on operations must be earned in order to pay the required return to debt holders. Further, in line with the Glas Cymru analogue, Network Rail was supposed to earn additional profits in order to build up a ‘buffer fund’ so as to isolate debt from day-to-day commercial risks, a function normally fulfilled by equity.

In any case, the intention was that major new investments would continue to be undertaken by ‘special purpose vehicles’ (SPVs): contractual arrangements with private sector providers. This idea predated the creation of Network Rail and was intended to harness private sector project management skills and to benefit from the stronger balance sheets of outside companies. Ironically, these SPVs would be financed by both equity and debt, so even the claimed elimination of ‘for dividend’ equity was illusory. It is unclear how SPVs would be constituted, or whether they would prove to be a practical proposition in the highly complex and inter-connected system that is an operating railway. The determination of both incremental cost and incremental revenues attributable to a new project would have been difficult and likely contentious.

There is considerable confusion about the governance of Network Rail: ‘who is it accountable to and for what?’. It is far from being under the kind of direct control of government that it would be if it were nationalised. Indeed, in order to satisfy the crucial test that allows the debt to continue to be classified as private, off the public balance sheet it is necessary that the public sector ‘not’ be in control of the company.

Under the original privatised structure everybody understood that the board of Railtrack, like the board of any public company, had a legal duty to serve the long term financial interests of shareholders subject to the constraints defined by normal legislation and by the rail regulator. The accountabilities and incentives under the new structure for Network Rail are much less clear. The Network Rail internet web site, http://www.networkrail.co.uk/, contains the following statements:

> “We are owned by our members but run by a PLC-style board….”. “The membership group is drawn from a wide range of industry partners and interested parties, including members of the public….”. The Board is “accountable to members, who do not receive dividends or share capital [or fees]….”. “The members have a duty to act in the best interests of the company …”.

Although Network Rail documentation says that “*Members will perform the corporate governance role normally carried out by shareholders in companies which have a share capital*”, it also states that members “*… are not liable in any way for the activities or finances of Network Rail and any of its subsidiaries…*” and “*… it will not be the role of members to set the strategic direction or engage in management of Network Rail…*”. There does not appear to be any clear, externally generated written statement of what the general public can expect from Network Rail in return for their financial support. The company memorandum & articles of association has no statement of public interest duties and little on what the company is to aim to achieve. In particular, there is nothing on balance between interests of:

[27] For an account see Gomez-Ibanez J A (2002), Glas Cymru and the Debate over Non-Profits, Teaching Case, Kennedy School of Government, Harvard.

- rail passengers present and future;
- railway employees;
- taxpayers;
- lenders;
- the wider public interest.

Most of the members will legitimately see it as their public duty to promote a larger, safer, higher quality and more expensive Railway. They will have less interest in efficiency and reducing the call on the taxpayer, which they are likely to see as the responsibility of the rail regulator and government. They are likely to perceive that overspend will result in additional claims to the government which government will find hard to resist.

In any case, it remains to be seen whether, in practice, the membership of over one hundred individuals is able to formulate a coherent set of policies and then whether, in practice, it can get the powerful executive board to implement those policies. The doubts were well illustrated in July 2004 at the Network Rail annual meeting (Daily Telegraph, 22 July):

> "The chairman of Network Rail said yesterday it was irrelevant what the travelling public thought of the company's decision to award its directors big bonuses. Speaking at Network Rail's annual meeting in Cardiff, Ian McAllister gave a robust defence of the award of £437,000 of bonuses to the five executive directors despite the company missing its train punctuality targets. The award drew fierce criticism from some of Network Rail's 70 public members, who dominate the company's 113-strong membership. The members are expected to play a role similar to shareholders in holding the company to account.
>
> Robert Barton, a public member, said: "If you ask the public what they think is a fair bonus they say 5% or 10% of salary. If you say the people I'm talking about are those who run Network Rail they splutter food all over them and say, 'Zero'."
>
> Mr McAllister shot back: "You may be a public member but you were appointed to act in the best interests of Network Rail. What other members of the public think about it or tell you is irrelevant."…
> Patricia Steel, another public member, said such comparisons were not valid. "Network Rail is a special company", backed by £21bn of taxpayer support. It is not equivalent to a FTSE 100 company. I think it's absolutely inappropriate for the executive team to have a bonus." Even so, she applauded the company's recent progress….".

This illustrated the fundamental weakness of the membership should they wish to impose a policy at odds with that of the executive board.

The concept of a company limited by guarantee serves many situations well and has an honourable history. However, there is a question as to whether it can bear the weight placed upon it by a very large, geographically dispersed and complex engineering operation that is subject to severe commercial risks as well as sustaining a high profile in national politics. The structure puts greater reliance than the previous regime on the industry's regulatory bodies, in particular on the rail regulator. He has already expressed concern about the incentives that face the board in the absence of share holder disciplines and that was one of the reasons he made a performance-related pay schedule for the executives a formal condition of the Network Rail operating licence.

Arguably, the restructuring of Railtrack into Network Rail changed little, did little to address whatever were diagnosed to be the fundamental failings of the structure of the railway after privatisation and yet it weakened and obfuscated the infrastructure company's objectives and created weaker incentives to look after the interests of the taxpayer. As the Parliamentary Transport Select Committee said (2004, paragraph 13), it is hard to avoid the conclusion that the government:

> "added 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".

The Select Committee goes on to conclude (paragraph 59) that:

> "the actions of the rail regulator to strengthen the terms of Network Rail's network licence may be welcome in themselves, but they are no substitute for sound day to day management and powerful managerial accountability to the owner. We do not believe that appropriate accountability is demonstrated at present by the company".

In spite of the weaknesses in the initial management of Railtrack, recent and careful statistical analysis by Kennedy and Smith confirms that:

> "Railtrack delivered substantial real unit cost reductions in the early years after privatisation (between 5.9 and 7.9% for maintenance activity; and 6.4 to 6.8% for overall maintenance and renewal activity)…. However, these improvements were largely offset by the post-Hatfield cost increases, which resulted in unit cost increases of 26 and 38% for maintenance and overall (maintenance and renewal) activity respectively". [28]

There is little doubt that Network Rail now has better senior management. They are successfully re-introducing sound engineering practice into the way the business is managed. They are committed to bringing the runaway cost back under control. Whether the incentive structure they are working with will enable them to succeed in the long term is an open question.

Railway engineering

As we have noted, the original design for rail privatisation conceived of Railtrack as a small organisation with the job of procuring the services it required from other providers. Engineering work for repairs, maintenance and enhancements was to be procured competitively. This is, of course, the major expense for the infrastructure company.
Elementary and damaging errors were made in this area at privatisation. Before privatisation the old British Rail engineering operation was divided up into several separate, territorial organisations. These were then sold to the private sector and were bought by general civil

[28] Kennedy J and Smith A S J (2004), Assessing the Efficient Cost of Sustaining Britain's Rail Network, Journal of Transport Economics and Policy, May.

engineering concerns, many of them large, well known companies. The first error was that they were sold with the benefit of negotiated procurement contracts already put in place by government. In other words, there was not an open competition to determine the terms on which Railtrack would procure what they needed. This may have been because the outgoing Tory government was determined to complete the rail privatisation in the little time they had before the general election, leaving inadequate time for a proper competitive tendering exercise. Another view was that the pre-arranged contracts had been struck on generous terms in order to inflate the sale price of the engineering companies at a time the exchequer was in particular need of funds.

Whatever the reason the consequence was that the benefits of fully competitive procurement contracts were denied to Railtrack at the crucial start of the new regime. This was unfortunate, given that the one of the largest potential gains from privatisation in general has been found to be the reduction in quality-standardised unit costs from competitive procurement in place of in-house procurement within the public sector (typically of the order of 20% before contract administration costs).[29]

A second error was that Railtrack failed to put in place adequate contract management arrangements. It was not understood that active contract management is an absolute necessity in situations like this in order to affirm that the work being paid for is being done to the agreed standard. One cannot just let a contract and then leave it to the contractor to deliver what has been promised. Railtrack allowed the competencies of its own engineering staff to atrophy so they lost the ability to be an intelligent purchaser: "*Railtrack didn't have a clear idea of what work was being done for the price paid*" (National Audit Office, 2004a). The maintenance companies recruited new staff of varying degrees of experience in the railway business and gave them variable amounts of training. Some of the maintenance companies were better than others but there were some highly visible failures, some of them safety-critical. It is alleged that poor communication and defective workmanship contributed to several accidents including Hatfield (maintained by Balfour Beatty) and some defective track components at Potters Bar (maintained by Jarvis).

A new generation of track maintenance contracts was introduced from 1999 with a retendering process. These moved away from fixed price contracts towards cost re-imbursable, open book pricing. They were intended to provide greater transparency and improved information on costs and outputs. Unfortunately, the benefits of these new arrangements did not have time to show through before the Hatfield accident in October 2000. A further problem with re-tendering was the limited pool of contractors to draw on. Only one new contractor was brought onto the rail system. Usually re-tendering involved reassigning contracts from among the same limited pool. Competition in the market for procurement of civil engineering work on the railway appears to have been limited by barriers to entry and the perceived safety and reputational risks.

When the contracts came to be renewed there seemed to be a lack of certainty about how the procurements should be managed and what should be the nature of the contractual arrangement. Eventually, in 2003, Network Rail made the decision progressively to terminate its outstanding maintenance contracts and to bring the function back in-house, whilst continuing to procure enhancement work from the private sector. Some of the private sector providers (notably Jarvis) decided to leave the railway sector.

[29] See Domberger, 1998 and Glaister S, Kennedy D and Travers T (1995), London Bus Tendering, Greater London Group, March 1995.

This should not force the conclusion that it is impossible or undesirable to employ competitive procurement for rail engineering services from the private sector. It just means, as with any infrastructure business, that care has to be taken to ensure the contract terms are appropriate and that they are properly managed and enforced. After all, the physical work has to be carried out either way and the problems of specification and supervision remain either way. These are particular problems in railways because safety often requires absolute consistency and the work often has to be carried out in remote and exposed locations meaning that more attention has to be given to achieving adequate supervision. As we have already noted the fact that private contractors make profits is not, in itself an argument against using them because ‘normal’ profits must be earned by in-house contractors too even if they are not transparent. It is ‘excessive’ profit that can be a problem and one way to prevent this is to ensure repeated and active competition for the contracts.

In the long run Network Rail may or may not succeed in reducing their engineering costs by bringing the function in house but evidence has not been presented to demonstrate why this would be the case. What is certain is that there will be substantial costs of buying out the existing contracts and transferring a large number of employees onto the books of what was a relatively small employer, and thereafter managing the employment and the labour relations in what is a notoriously difficult industry. A risk is that individuals previously working under terms and conditions close to the going rate in the general civil engineering world will quickly come to expect those available in the railway industry, as illustrated in Figure 1. That might lead to a rapid increase in labour costs for Network Rail.

The overall conclusion is that one of the major potential sources of efficiency gain from rail privatisation - competition in the labour market for civil engineering work - was never achieved. No doubt the philosophy was not explicitly articulated because of its special political sensitivity in the case of railway employees. In any event lack of clarity about what contracting out was trying to achieve ultimately led to failure.

5 THE LATEST NEW RAILWAYS POLICY- 'THE FUTURE OF RAIL'

In July 2004 the government published the outcome of a review of its railways policy, The Future of Rail. This review had been precipitated by a number of factors, including the general public dissatisfaction with the performance of the railway, with the principle of privatisation and the political imperative 'to be seen to be doing something'. But the most immediate problem was caused by the outcome of rail regulator's special review of Network Rail's access charges, undertaken in the aftermath of Railtrack's failure, published in December 2003 and coming into force in April 2004.

This contained bad news for the government. The regulator judged that the basic costs of Network Rail were going to be higher than had been thought before Hatfield (NAO, 2004a). In 2004 public funding for the railway has risen to £3.8bn, up from £1.8bn in 97/98 (DfT, 2004, paragraph 2.2.1). In addition the year in which Railtrack rotted in administration whilst the government put together a viable solution, together with a serious, if possibly temporary, rise in the cost base when Network Rail finally stared to trade, had contributed towards a very rapid increase in Network Rail's debt. This had already increased from £585m at privatisation to £9,404m by March 2003 (NAO, 2004a, paragraph 3.10). There is provision for the future debt to rise to as much as £21bn if necessary.

Increased track access charges by Network Rail are passed on directly from the TOCs to the SRA and thus, ultimately, to the Treasury. The Treasury was unhappy to be presented with an annual bill for running the railway which had very much increased in spite of the regulator having agreed to some of the payments being deferred by further increasing debt. This flew directly into the face of everything the Treasury had been trying to achieve for the railway for decades, and for a period thought they had successfully achieved with rail privatisation. The Department for Transport were additionally concerned because the increases in rail costs made a nonsense of the Ten Year Transport Plan which had previously been agreed with the Treasury. [30]

The government sought to blame the increase in the burden on the tax payer on the independent regulator, complaining bitterly that he was high-handedly setting taxpayer-funded levels of public expenditure, which he had no constitutional right to do. In this it was supported by a report from the all party Select Committee of the House of Commons (Transport Select Committee, 2004) which, uncharacteristically, seemed to have been swayed by public and political sentiment rather than by accurate analysis of the facts.

The regulator has given a clear and convincing account (Winsor, 2004a, b) of the real constitutional position, explaining that he had simply done what the law required of him, namely to determine how much an economic and efficient infrastructure company in current economic circumstances should be paid for delivering the outputs that the government, through its agent the SRA, had asked for. It was for the government to decide whether it could afford the bill and if not, to reduce the volume of work it was specifying. There had been an attempt to 'shoot the messenger'. At base the problem was one which has bedevilled government involvement in railway policy for decades. On the one hand the Treasury is unwilling to find the relentlessly increasing money the railway demands of the exchequer and on the other the government is unwilling to face the political difficulty that any move towards

[30] DETR (2000), Transport 2010: The 10 Year Plan, July.

contraction of the railway would involve. This problem remains for the future and it is unresolved.

Early in the review process the secretary of state (by now Alastair Darling) explicitly and publicly recognised that, so long as anything like the current structure of the railway survives, his predecessor's attempts to weaken the position of the independent regulator were unwise. At the very least his or her strong and visible independence is absolutely necessary to protect the private sector interests that the government are looking towards to continue to invest on a large scale. The political and policy risks are now better understood by investors.

This position is confirmed in The Future of Rail. In fact this rather vague document proposes remarkably little fundamental reform. The basic structure of the industry is to remain unchanged. Network Rail will remain as the regulated monopoly infrastructure provider and privately owned passenger and freight train companies will continue to operate on either a contracted or open access basis. The one major change proposed is that the Strategic Rail Authority will be abolished and its functions will be transferred into the Department for Transport. Since the SRA (and its predecessor, the OPRAF) has always been a 'non-departmental public body', subject to direction from the secretary of state, this may not seem to be a very radical change.

It is certainly deeply ironic that the only major change is to abolish the only railway body that Labour created during the whole of its seven years in power, having been deeply critical of rail privatisation since the legislation was first debated in 1992. The Future of Rail states that:

> "… the SRA is in a difficult position. As a public sector body, it cannot lead the industry from within, and there are limits to its ability to set the strategic agenda for the railways - which in practice must be the responsibility of ministers" (paragraph 1.4.19).

This seems to be a clear admission that the reform in 1998 under Mr Prescott, which took over two years to fight through to the statute book, is now regarded as misconceived and unsuccessful in its objectives.

It is tempting to argue that it was decided to abolish the SRA because, having committed to 'doing something', that was the only thing the government could easily change short of complete renationalisation of the industry. Renationalisation might have been popular with the general public but it has always been ruled out by the Treasury on grounds of cost to the exchequer (the obverse of using the proceeds from utility privatisation to fund general public expenditures) and, particularly, because it would have put the Network Rail debt onto the public balance sheet. That is something the Treasury is absolutely determined to prevent.

If renationalisation was ruled out then the government had to preserve much of the existing structure. We have already noted that the government recognised an early stage of the review that the powers of the independent regulator must not be compromised in order to keep the private investors willing to invest in the industry. Network Rail had only recently been created at enormous expense as a new form of 'private' corporation and presented as the new way forward. Furthermore, the government had already claimed that the new corporation was beginning to succeed in getting control of its costs which was the primary reason for having created it.

Relatively small changes are to be made to the TOC contracting regime. That only left the SRA as a target for headline change. There was one major reason that the SRA came to be perceived as having failed - and was always bound to fail. It was never given enough money to deliver the task that government expected of it. The two and a half years between promising to set it up in the 1998 white paper and finally passing the legislation in late 2000 was symptomatic of the ambivalence and lack of commitment within government. The SRA had to operate in 'shadow' form for this period: remarkable that a public body responsible for a great deal of public money should be expected, and allowed, to operate for this long on the basis of pretending it had legal powers that it did not have.

From the first the chairman of the Shadow SRA emphasised the problem of insufficient funding: the late Sir Alistair Morton repeatedly said the fundamental needs of the railway were 'investment, investment and investment'. The SRA's funding problems became greater as first the TOCs ran into financial difficulty and had to be rescued and then track access charges increased in response to Railtrack and Network Rail's cost problems.

There were other reasons that the SRA came to be perceived as a failure: it came to be remarked that it was neither strategic nor authoritative. In the earlier years strategy documents were promised and then repeatedly delayed, ultimately to be substituted by a 'Strategic Agenda' which appeared to be more of a personal statement by the chairman.[31] Relationships with the rail regulator were unhelpfully difficult. The institution was not good at making clear to the general public what its criteria were for allocating the limited funds available. There was much confusion over franchising policy with indecision about what an appropriate franchise length might be.

More recently the SRA, under the chairmanship of Richard Bowker, took a stronger line in attempting to promote the case for more railway funds to government and the general public. This ought to have found strong support amongst the general public but documents such as Everyone's Railway were unconvincing special pleading and proved no match for the displeasure of the Treasury at the poorly justified claims for ever more public money.[32] More importantly, a central part of the 'strategic' function, which the government had identified as a weakness to be remedied in the structure it had inherited, was to promote major schemes to enhance the network. This was to be done in partnership with the private sector through 'special purpose vehicles'. We have already noted the conceptual difficulties with these in a railway context. Few were worked up in any detail, only one reached the stage of commercial negotiation and none was successfully concluded.

Like the shortage of sufficient funds to do the job the government wanted doing, it was hardly the fault of the SRA that they were being asked to work in a way that was impractical. But, as with the funding problem, it might have been more productive in the long run if the SRA had been more ready to recognise the difficulties and to force a debate in public about how they might be resolved.

Of course, the major obstacle to this was that the SRA was not independent but was a part of the government machine and was therefore disinclined publicly to criticise current government policy. This is pertinent to the new proposal to bring the SRA fully into a government department. There will be a further loss of independence and transparency. For all its failings the SRA does have some advantages which will be lost. There is a separately identified budget which the SRA must account for. The SRA now routinely publishes

[31] Strategic Rail Authority (2001), Building a Better Railway, March.
[32] Strategic Rail Authority (2003,) Everyone's Railway: The Wider Case for Rail, September.

financial and service performance data for the services it is responsible for (see for example, the SRA Annual Report, 2004, Appendix 5). Now the public can see how much public money is being spent in support of each of the franchises. Achieving this transparency was one of the objectives of the rail privatisation policy and it has been valuable. Much more is known about how much different things cost. Inevitably the information can be quite embarrassing: for instance, we now know that the amounts of subsidy vary from four or five pence per passenger kilometre for the London commuter franchises (where one might expect a case for rail subsidies on congestion relief grounds) up to as much as 30 or 40 per passenger kilometre for some of the more rural franchises. This ought to stimulate public debate about whether the public wishes to continue to support all of these activities.

But these debates have always caused political difficulties for governments and it seems unlikely that the same level of transparency will be preserved from within a government department. The history in the UK and elsewhere shows that governments are not good at running railways. Under the new arrangements the important policy matters will be under much more direct government control than they were in the days before privatisation. The British Railways Board was a separate public corporation with some independence over fares, investment and closures. Now a government department will be deciding these things. The problem of political intervention will be hard to manage. Ministers will be under pressure from back benchers and Cabinet colleagues to intervene on matters both major and minor. The business will become even harder to manage than it has been so far.

The Future of Rail contains unresolved issues. In the foreword the secretary of state speaks of "*An inefficient and dysfunctional organisation coupled with a failure to control costs*". The document claims that "*the attempt to create a commercial market relationship between the train and track companies failed*" (paragraph 1.2.1), and speaks of "*misaligned incentives*" (paragraph 1.4.12). However, in spite of this diagnosis, the government's new proposals do not seem very different from the current situation. Competition for train franchises is to remain: "*… having train companies compete for the right to operate services can be advantageous… it would be much more difficult to secure effective competition if track and companies were merged to create regional monopolies*" (paragraph 4.2.5). The ownership structure is not to be changed: "*The government believes that the best way to secure these objectives is through maintaining the principle of public and private partnership but without the poorly constructed relationships and incentives which have hampered the industry in its current form*" (paragraph 4. 2.2).

At several points the document comments on the unsatisfactory nature of the incentives created under the current contractual regime, yet there will still have to be formal relationships of some kind between bodies with different owners: "*… it is vital nonetheless, that track and train companies work closely together with aligned commercial interests at local level … This means having clearly defined responsibilities and shared objectives, but it does not mean common ownership*" (paragraph 4.2.8). "*The weakness of the current structure … is the complex and adversarial relationships between the different parts of the industry. The government believes that these will be better remedied without moving to common ownership…*" (paragraph 4.2.9).

There is still to be some kind of commercially-based payment regime under what is referred to several times as "*binding arrangements*" as in "*under this new structure:… there will be binding arrangements between government and each side of the industry, instead of the current distorted market structure*" (paragraph 4.3.2). "*The penalty regime between the train companies and Network Rail… will be simplified to reduce bureaucracy whilst still ensuring that train companies are compensated in the event of underperformance from Network*

Rail…" (paragraph 4.3.26). "*The franchise contracts between the government and the train companies will be aligned with the government's binding arrangement with Network Rail…*"(paragraph 4.3.7) "*… the binding arrangement with Network Rail will also cover investment…*" (paragraph 4.3.22).

The document gives no detail of what is the notion of a "*binding arrangement*" with a financial penalty regime and how it might differ from a conventional commercial contract.

The accountability of Network Rail presents another unresolved problem. The Future of Rail states that "*Network Rail will therefore be held accountable under the new regulatory and contractual arrangements for the operational management of the network, and for co-ordinating the industry's planning…*" (paragraph 4.3.11). Yet Network Rail is to remain as currently constituted. As argued above, public accountability is problematic. As a matter of definition in order to keep the debt off the public balance sheet the public sector *must not* be under the control of Network Rail. This tension will be even harder to live with once the SRA has been taken into the bosom of a government department. As the NAO (2004a, paragraph 6) notes "*…SRA support… remains fundamental to Network Rail's long term debt finance*". The financial press has repeatedly reported that the interest cost of the long term borrowing that Network Rail is securing is being reduced by the comfort offered by the underlying government support. But if the government is perceived as supporting the debt in any case, one has to wonder why the government does not borrow directly in order to enjoy the low rates available to direct sovereign debt. The NAO (2004a, paragraph 8) remarks that "*The Department needs to bear in mind the relationship between the cost of Network Rail's debt and the extent of the SRA's credit support. If conditions in the financial markets change, the Department should assure itself that any wider benefits of indirect borrowing by Network Rail can still be shown to outweigh the potential cost savings from government directly supporting such debt…*". As with the London underground PPP (below) the government is in danger of paying risk premia to others whilst actually bearing all the risks itself.

There is clearly more detailed work to be done to make the new policy operational and only then will it be possible to judge how, if at all, it differs from the regime it is replacing. However, another irony is already clear. The government, having attempted to subvert the powers of the independent rail regulator at the time of putting Railtrack into administration, notes that "*as infrastructure costs have risen, the rail regulator has played a more pivotal role…*" (paragraph 3.2.3). Now the government is seeking to rely more heavily on the Regulator: "*… Network Rail will be held accountable though enforcement by ORR in the event of poor performance or a failure to keep to budget*" (paragraph 4.3.8). "*… outputs would be set out in the government's Statement of Reasonable Requirements and the ORR will have a duty to enforce Network Rail's delivery of them*" (paragraph 4.3.15). This Statement would be "*… for the purposes of Network Rail's licence. It would therefore be binding upon Network Rail, and the ORR would be obliged to enforce it*" (paragraph 3.1.7).

Can a privatised railway be made to work?

The adverse public comment about the current privatised rail structure has often criticised 'fragmentation' of the ownership of the industry and has asserted that it is not possible, or undesirable, to separate ownership and responsibility for operating train from ownership and responsibility for the track and other infrastructure. Little or no hard evidence is adduced in support of such propositions and it seems that, rightly or wrongly, the government has been unconvinced by them in the present review because it has left the situation largely unchanged. The practical experience of the early years of the history of railways in the UK, of UK rail privatisation of 1993 and of the London underground (see below) demonstrate that it may or may not be the best way of proceeding but it can be done.

It manifestly can be made to work in a stable and fairly predictable way, but only on three crucial provisos. First the legal system must be sufficiently competent, robust and respected to put in place the necessary contractual arrangements: there has never been any doubt about this in the UK context. Secondly, it must be possible to specify an appropriate performance regime that will provide the incentives induce the required behaviour. This is open to question: there are both analytical questions (eg, what are the right financial penalties to use?) and legal questions (eg, can they be successfully drafted into contracts that are enforceable in practice). Finally, once created, these arrangements must be left alone to mature, without the fatally damaging consequences of interventions by government or others that undermine the incentives carefully designed into the ‘fragmented’ structure.

There is one fundamental reason to doubt whether the structure now proposed for the railway can operate successfully for very long: unmanageable debt. Railtrack’s year in administration, the subsequent increases in costs, the realisation that more needs to be invested, the borrowing at the request of government in order to reduce current taxpayer funded grants, government’s aspirations to carry more rail traffic and its refusal to countenance large scale closures all lead to one place: rapidly increasing debt for Network Rail. The original intention was that Network Rail would earn profits and would retain these in order to build up a buffer fund designed to cushion commercial risks, the function normally performed by equity. In fact, no such profits have been earned and none look likely. Rather, debt has escalated. Given the relatively weak consumer markets that Network Rail’s customers operate in and the inevitable failure of government greatly to increase its recurrent grant, it is very hard to see how Network Rail will ever repay - or even bring under control - debt on this scale. Late in September 2004 the Financial Times (Robert Wright, 24 September) reported yet another change of policy on Network Rail’s debt:

> “The move… will allow the company to replace a planned securitisation - a fundraising secured against future revenues - with a simpler programme of long term debt-raising at interest rates closer to those for government debt…. Under the new arrangement the government will issue a long-term indemnity to back all Network Rail’s borrowing. The Office of Rail Regulation will add a clause limiting the company’s total borrowing… The new structure will enable the government to dismiss the chairman and chief executive if the company makes any call on the government guarantees”.

This must surely re-ignite the debate about whether the Railtrack debt can really be defined to be off the public balance sheet, despite the report noting that the Office of National Statistics did not expect the changes to alter the office’s assessment of the company’s status.

As always, history offers a lesson: government’s refusal to write off unrepayable debt prevented the industry functioning properly throughout the 1950s, 1960s and 1970s (Shaoul, 2004). Distorting future managerial and commercial decisions in a vain attempt to repair the damage caused by past policy errors is not sensible. The government’s determination to keep Network Rail in the private sector and to keep its debt off the public balance sheet, together with its reluctance to countenance a sufficient increase in access charges to enable it to deal with its debt problem do not auger well for the long term financial sustainability of Network Rail.

The London Underground public private partnership

In view of Labour's opposition to rail privatisation and the way they sought to modify it once in power, their simultaneous creation of the public private partnership (PPP) for the London underground, announced in March 1998 and completed in December 2003, is full of ironies and contradictions.

It was proposed as a solution to the widely accepted problem of historical underinvestment in the upkeep and current maintenance of the London underground. The hope was that procurement under a set of long term contracts could achieve the provision of early capital investment without increasing explicit government borrowing. The government's advisers anticipated continued growth in fares revenues from the underground and the government were persuaded that over a long period the revenues would prove sufficient to service the private sector's capital investment in full. This led them to design thirty year contracts in the belief that this would enable them to negotiate an infrastructure service charge that could be fully funded out of revenues thus making the investments self-funding over such a contract period. Thus, the underground would be brought up to a proper standard of repair, there would be some capacity increase, and yet the call on the exchequer would be zero from the beginning. This hope proved to be wildly over-optimistic: in the event the call on the exchequer turned out to be over £1bn a year. It is important to note that the PPP only relates to the existing underground and makes no provision for major new works such as new underground lines.

The government anticipated that the use of private sector providers would achieve the same kind of efficiency gains as had previously been achieved in the privatised utilities. But, in order to meet the 1997 general election manifesto commitment not wholly to privatise the underground the privatisation only relates to the fixed infrastructure, signalling and trains, whilst operational staff - train drivers and station staff - remain as public sector employees of the newly-created Greater London Authority. Thus, approximately 64% of the staff have remained in the public sector. The remainder transferred to the private sector, but, crucially, their terms and conditions were protected in accordance with the commitment made by the deputy prime minister at the time the scheme was announced. In addition to this split between operations in the public sector and maintenance and renewal in the private sector, the private sector involvement is itself subdivided into three separate contracts. Thus, whilst criticising the fragmentation and vertical separation brought about by the Tories for British Rail the Labour government simultaneously created a slightly different, four-fold fragmentation and vertical separation for the London underground.

The government divided the infrastructure into parts based on three sets of lines:

- Jubilee/Northern/Piccadilly;
- Bakerloo/Central/Victoria;
- District/Circle/Metropolitan/Hammersmith.

However during the competition for the contracts the government decided that the last two of these would be owned by a single consortium. The successful bidders were consortia of established companies:

- Amey/Jarvis/Bechtel;
- Atkins/Balfour Beatty/Bombardier/Electricité de France.

Some of these were new to the railway business and some were well known from their involvement in the privatised railway.

The PPP contracts follow the principle of being output-based. The contracts say little about how results are to be achieved, but they give financial incentives for achievement. The incentive payment regime has main components relating to 'ambience', 'capability' and 'availability'.

The availability measure is probably the most important: "*Infracos are rewarded or abated depending on the performance of each line relative to its benchmark. Performance better than benchmark results in a bonus of £3 per lost customer hour while performance below benchmark incurs an abatement of £6 per lost customer hour. Performance below a level defined as 'unacceptable' incurs an abatement of £9 per lost customer hour. There are various additional contractual remedies available to LUL should performance fall below the benchmark or unacceptable levels*". The government's original intention was that the contracts would be completed and then transferred to the newly-elected Greater London Authority in spring 2000. However, this proved infeasible, and final agreement on the main commercial terms was delayed until late 2003 and after expenditure of at least £450m on consultancy and legal fees alone.[33]

The first London executive Mayor, Ken Livingstone was elected in 2000. He was deeply opposed to the PPP. He recruited Bob Kiley from New York as Transport Commissioner for London (chief executive of Transport for London). There was never dissent that engineering services should, where appropriate, be competitively procured from private sector providers. But Kiley recognised the difficulties that would be created by the monopoly power granted under very long contracts to non-competitive providers. It would be hard to secure good value for money, hard to ensure service delivery to the required quality, hard to manage safety and hard to secure changes to the terms of the agreements as the development of policy required it. As an alternative he proposed a system of many more, much shorter contracts.[34]

Further, Livingstone and Kiley pointed out that the PPP structure was not necessary in order to secure the required capital - providing the government were willing to allow the debt onto the public balance sheet. The system revenue bonds successfully used for years in New York and many US cites could have been used.[35] But the government would not change policy, the suspicion being that an important reason for this was that the Treasury wanted to impose the contracts in order to fetter the power of the mayor over spending on the underground infrastructure. The PPP certainly has that effect. Ironically, the debt created under the PPP has now been classified as on the public balance sheet. Further, as we have noted, the government is actively encouraging Network Rail to use what are effectively revenue bonds to raise the long term borrowing it needs, even though they are determined to keep Network Rail's debt off the public balance sheet (NAO, 2004a, paragraph 3.18).

Under the supervision of the Commissioner for Transport in London, LUL is in the process of creating the administrative systems to manage the contracts from its side. In order to create the necessary asset registers and to populate the management information systems LUL relies upon receipt of accurate and timely information from the infrastructure companies (infracos). Of course, the infracos themselves have to create this information for their own purposes, in itself a major task in view of the myriad of different and incompatible sources they inherited.

[33] National Audit Office (2004b), London Underground PPP: Were They Good Deals?, HC 654.
[34] Transport for London (2001), Proposed Management Plan for the London Underground, April.
[35] Glaister S, Scanlon R and Travers T (2000), Getting Partnerships Going, Institute for Public Policy Research.

The importance of this issue is clear from the consequences of failing to resolve it in contributing to the commercial failure of Railtrack.

The government has emphasised that this is not a conventional Tory utility privatisation, even though the situation will be rather similar to the privatised utilities: private, for profit consortia in monopoly control of essential network facilities, receiving fees for access. But there is no regulator. Protection of the public interest for the next thirty years will depend crucially on a regime of contracts presided over by a statutory arbiter. In contrast the duties of the rail regulator those of the PPP arbiter are to help enforce the agreements at the ‘time the contracts were signed’. The powers and duties are set out only in the barest terms in the legislation because the detail is explicitly delimited in the complex and inaccessible PPP agreements.

There is at least as strong a need to protect the public interest in the operation of agreements granting monopoly powers for thirty years to private sector controllers of the essential London underground infrastructure as there is for the privatised utilities. Parliament had this in mind when it created the post of Statutory PPP Arbiter in the GLA Act 1999. However, the arbiter’s public interest powers are less than those of the independent utility regulators because arbitration on an historically-agreed contract is different from forward-looking regulation, because the legislation limits the arbiter’s scope and, more particularly, because the powers are given effect by the wording of the contracts and these were weakened in late negotiations. The infracos are to receive payments that will ensure that they can achieve at least the equity rates of return agreed in the original contracts providing they are ‘efficient and economic’. In other words, this is similar to a regime of rate of return regulation.

Very little role is envisioned for competition. Being thirty years in duration there will not be the discipline of repeated competition for contracts. The PPP agreements provide for two of the infracos to procure vital assets exclusively from within the membership of their consortia. They have in place ‘long-term supply contracts for the supply of new trains and signalling, the maintenance upgrading and renewals of civil assets, track renewal and maintenance, refurbishment and modernisation of stations on a pre-agreed pricing basis as deemed appropriate by infraco…’. The arbiter is unable to question the terms and conditions under which the infraco is procuring the services that form the core of what is to be provided under the PPP. The technologically risky project to replace conventional signalling with a moving block system is also pre-defined to be efficient and economic.

In early drafts of the contract there were various limitations on the types of costs for which the Infraco could seek reimbursement at review, including a restriction on further contingencies for routine maintenance and renewal work and on costs associated with additional finance taken out in the first period. These have fallen away, presumably as part of the effort to protect the infracos from cost overruns. The government’s hope is that the vast majority of disputes will be amicably settled in a spirit of ‘partnership’. This is ironic given that the government have been heavily critical of a culture of bureaucratic disputes handling amongst the ‘fractions’ of the privatised railway.

The fact that the ‘client’ for the private services is a directly elected public authority that had no part in negotiating the contracts but will have to administer them and is liable for the payments will make the commercial relationships prone to disputes. Most obviously, what the contracts incentivise was set by central government and it may not be what a mayor might have chosen. Large contracts work best when both sides are clear what is required and both sides are confident that what is being done is what the client wanted. Since the GLA was given no part in negotiating the contracts it is unlikely that they will align with the GLA's objectives.

Although there was initially an open competition for the PPP contracts, once the preferred bidders had been selected there was along period of negotiation during which the risks accepted by the bidders were significantly reduced (National Audit Office, 2004b). The original draft contracts had already placed important caps on the liabilities faced by the contractors. Consequently, the final contracts greatly limit the magnitude of the risks that the investors are facing - and there is very little equity investment in any case.[36] The end result seems to be that high service charges are being paid to monopoly service providers to guarantee them high rates of return on capital (National Audit Office, 2004b), whilst they bear little risk. This is again ironic given the objections of Labour to the earning of profit by infrastructure companies in the privatised railway.

Full responsibility for London underground operations and for the PPP contracts passed to the Mayor and Transport for London in June 2004. It is far too soon to have definitive objective evaluation of the outcome. However, there have been two preliminary official studies.[37] The Transport for London review notes that:

> "Good management can overcome some of the shortcomings we have observed in Infraco planning activities, but all the parties to the PPP remain captive to the limitations of the PPP contracts themselves. It is likely that there will need to be changes to the PPP contracts reflecting actual experience during the first year or two of their execution. We will also be evaluating whether the financial incentives engrained in the contracts in fact motivate appropriate behaviour and outcomes, and whether the work the infracos elect to perform is the highest priority work in the light of the condition of underground assets and the needs of underground customers" (Transport for London, 2004, p5).

Already a consensus is emerging on both sides of the contracts that it will soon be sensible to renegotiate some of their terms. And already several of the consortium members have run into serious financial difficulties (for reasons not all to do with the underground PPP) - Amey has been taken over by a Spanish company and Jarvis breached its banking covenants and (at the time of writing, autumn 2004) is being kept solvent through concessions by its bankers and has indicated that it wishes to sell its interest. There is a suspicion that government was concerned that at least one of the consortia members might fail before the contracts could be completed. It remains to be seen whether a Labour government would be willing to allow one of the PPP consortia to fail (as it did Railtrack) bearing in mind the political capital invested in pushing the PPP through bitter much opposition, much of it from Labour MPs and supporters.

All this raises again the fundamental question of the extent to which competitions for large, long-lived contracts for the provision of public services can, in view of the inevitable political interferences, be expected to produce the kind of value for money outcomes normally expected from the classical models of competition for contracts.

[36] Walder J and Amenta T L (2004), Financing New Infrastructures: Public/Private Partnerships and Private Finance Initiatives, in Hanley R E (ed) Moving People, Goods and Information: The Cutting-Edge Infrastructures of Networked Cities, Spon Press.

[37] National Audit Office (2004c), London Underground: Are the Public Private Partnerships Likely to Work Successfully?, HC 644 and Transport for London (2004), London Underground and the PPP: The First Year 2003/04, June.

6 CONCLUSIONS

The fundamental principle driving the British railways policy of the 1990s was not change of ownership (privatisation). It was the establishment of competition in every aspect of the business in order to achieve cost efficiency and also transparency of policy. The policy was designed so as to maximise the opportunities for effective competition whilst catering for natural monopoly in infrastructure and for the need to continue to pay subsidy in order to preserve the scale of the industry. It was successfully implemented and it started to produce some remarkably good results.

We shall never know what the long term outcome might have been if the policy, once implemented had been left alone. It soon fell foul of, and was ultimately destroyed by, two phenomena. First policy risk: the Treasury proved to be unwilling to provide the public funds necessary to allow competition for passengers to operate as originally envisaged. Competition had to be 'moderated'. There is doubt about whether the degree of on-rail competition originally envisaged in the white paper was even technically feasible. Also, a proper competition was not held for the right to provide by far the most important services to Railtrack, engineering, allegedly because that might have reduced the privatisation sale revenues for the Treasury. Finally, ministers were slow to make up their minds about exactly what they wanted, and execution of policy was unduly rushed because of a late decision to privatise Railtrack in advance of an impending general election.

Secondly, political risk: governments proved, in practice, to be unwilling to tolerate the criticism that they feared they would attract if they had allowed the company failures which are essential to an effective competitive processes. When train operating companies failed government bailed them out. When Railtrack made a fatally bad investment and mismanaged its information systems, government again rescued it for a while, before intervening in a way that destroyed the normal competitive market for corporate control. This greatly weakened the mechanism whereby competitive markets deliver cost efficiency - transfer of the risks of incompetence or paying too much for inputs from the state to the private owners.

Perhaps because of this, or perhaps because of other perceived political risks deriving from the special political sensitivities in relation to railway workers, the single most effective potential efficiency gain was not delivered. This would have been the introduction of a competitive market for labour. It had largely accounted for the success in previous privatisations of British utility companies, but unit labour costs in railways have run well ahead of average earnings. The government explicitly prevented it in the case of the London underground.

Crucially, there was a change of government soon after rail privatisation had occurred. The Labour party had been explicit whilst in opposition about its deeply felt commitment to reverse the rail privatisation. Once in power the new Labour government seemed to be uncomfortable with the notion of competition in the railway industry (though not, apparently in other areas of public service provision). It did nothing much for a while beyond minor interventions and loud criticisms from the sidelines. But it legislated to slightly (and ineffectually) change the agency responsible for administering subsidies (now proposed for abolition) and allowed itself to be drawn into controversies surrounding several railway accidents - although there was, and remains, no objective evidence that the railway has stopped its long term trend of becoming progressively safer since before it was privatised.

Then, when Railtrack, the privatised, regulated monopoly provider of infrastructure ran into terminal financial difficulty the government took its chance to give the public the appearance of recovering public control of the industry. But here again policy risk asserted itself: Treasury fiscal and national debt policy prevented renationalisation. Instead, on close inspection, both the new infrastructure company, Network Rail and the train operating companies now sit precariously on an indistinct boundary between public and private sectors with foggy corporate objectives and ill-defined duties towards the public interest.

No evidence or experience has demonstrated that one cannot separate rail infrastructure from operations if that is what is desired. Indeed, contrary to what the public may have been led to expect, the July 2004 review of railways policy clearly reaffirms this division for the future. Separately, and slightly surprisingly, the Labour government itself created just such a division (differently configured) with its new structure for the London underground, implemented a full six years after reaching power. Foster (2005) who was a close and authoritative observer of events both before and after rail privatisation is of the opinion that:

> "in practice [separation of train from track ownership] has led to comparatively few problems. I believe the best evidence that the vertical separation of train from track was feasible, is not only that rail privatisation continues on that basis, but that it has become central to rail regulation and interoperability of rail systems throughout Europe. Furthermore its retention was among the few givens when the Labour government reviewed the railways in 2004".

The recent review of railways policy leaves most fundamental questions unanswered - indeed, many are not asked. There is ambivalence about the role and meaning of enforceable commercial contract, and the associated performance incentive regimes. There is ambivalence about whether Network Rail is or is not private, whose interests it serves and whether it is or is not under government control. Little assurance is given that the historical and international experience that railways do not flourish when they are under the direct policy control of governments will not apply in this case.

Most importantly of all there is little sign of the fundamental issue being addressed: how big a railway operation is the nation willing to pay for over the long term? And, if it is not willing to pay the likely cost of the present scale of operation, what is to be cut? Network Rail's debt is already much higher than Railtrack's was and it has recently been further increased at the government's request by deferring some of the increased access charge payments as determined by the rail regulator. If Network Rail's unit cost fail to reduce as rapidly as the government hopes then there is a real risk of Network Rail quickly becoming burdened with an unmanageable debt: a return to the unproductive three decades of the debt-stricken nationalised railway, but without even the benefit of a semi-independent Railways Board with transparent accounts and objectives.

David Quarmby, now head of the SRA in succession to Richard Bowker who resigned on publication of the rail review in July 2004, has given the clear signal that there is unlikely to be sufficient funding available to carry out much enhancement work (The Times, 7 October 2004):

> "With the expected tightness of the government's spending review settlement for the next few years and given the increased funding going into Network Rail's renewal of the existing railway, I believe we are unlikely to see the recent scale of activity on new projects and enhancements [including the West

> Coast Main Line enhancements] continuing on this scale in the future…. John Armit, chief executive of Network Rail, said that there was no ten-year plan for the railway beyond the vague aspirations made in the government's Future of Transport white paper in July: "Without these long-term plans it's going to be very difficult for the supply side to plan for the future," he said".

The government's ambitious and explicit rail growth targets set out in the 2000 Ten Year Plan now appear to have been abandoned. But it is surely still policy that use of railways should increase. If so then there appears to be an important inconsistency in policy towards the railway.

The British experience illustrates that both the financial and the political costs of major structural reform, in order to involve competitive forces and private ownership into previously nationalised railways, are likely to be immense. But the cost to the public purse of railways is also immense. Competition, if allowed to be effective, may offer much more than enough gain to offset the costs of introducing it. Arguably this has been demonstrated several times with the privatisation of the other major British utilities. Foster (2005) notes that *"Though some relations [between the many bodies created at privatisation] proved difficult - mostly between government bodies; and between them and the industry - yet innumerable large private firms have continuing contractual relations with as many as 100 other firms"*.

Unfortunately, the British experience on railways may also illustrate the possibility of ending up with the worst of all worlds: to incur the costs of privatisation in order to harness the forces of competition but then to intervene to prevent that competition from delivering its benefits. And to end up paying private risk-bearing rates of interest on large debts without achieving any real risk transfer from the public sector. If competition is to be the driving force for policy, government intervention is still necessary: but it must be intervention to promote and enforce competition and to do what it can to assist genuinely competitive procurement and effective contract management.

A question yet to be answered - and the answer will vary from country to country is whether or not there is really something so special about railways that governments cannot, in practice, create an autonomous, competitive structure and then leave it alone. A moral of the British experience is that effective competition is possible in many dimensions of the provision of railway services, but that it is pointless for governments to introduce it unless they can deliver on the commitment to allow it to function.

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