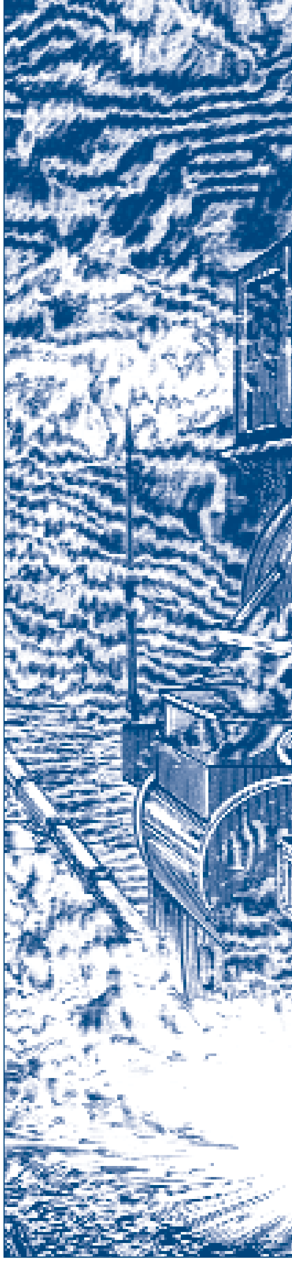
HOW PRIVATIZATION BECAME A TRAIN WRECK

BY ERIC MORRIS



September 15, 1830, saw the grand opening of the world's first steam intercity passenger railway. It also saw the first railway death, when William Huskisson, prominent Tory MP and railway supporter, misjudged the speed of an approaching locomotive and was run over. He was not to be the last British politician to wish he'd never had anything to do with the railways.

From 1994 to 1997, John Major's government conducted an audacious privatization of British Rail. The system was broken up into almost a hundred pieces and sold. Ten years later, disgust with the privatization and its aftermath cuts across British society. There are few stakeholders, from riders to drivers to railway executives to shareholders to regulators to politicians, who do not consider the experiment a dismal failure.

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The Push to Privatize

There are various theories as to why the Tories decided to break up BR. Those who ascribe baser motives to the government's actions focus on its allegedly Thatcherite, ideologically blinkered lust for privatization for privatization's sake. Other less reputable motives may have included a desire to trim the sails of organized labor or a philosophical antipathy toward rail (as it represents a "collectivist" form of transport as opposed to the "individualist" car).

The government maintained its hand was forced by the poor performance of BR and its rapacious need for subsidies. The Tories felt the railroad's monopoly status encouraged bureaucracy, low productivity, and an inattentiveness to customer needs. The government believed the antidote was markets and competition, which would promote efficiency and innovation. The Tories also claimed they wanted to create an "ownership society" and put the railways in the hands of the people. For his part, Major maintains he acted because BR was underfunded and needed to tap the markets for fresh capital.

There was considerable debate over the form privatization would take. The more cautious wanted to sell BR as one unit, break it into vertically integrated regions, or "sectorize" by dividing the business into intercity, regional, and freight companies. These plans were rejected on the grounds that they would not foster competition. Instead, the government decided to create multiple train operators who would be free to compete on any part of the network. In order to have a level playing field with ,

open access, it was decided to separate ownership of the track from ownership of the train operations.

The dismemberment of BR created a large and complex jumble of interlocking firms. The engines and rolling stock operations were divided among three separate companies known as ROSCOs that leased the trains to 25 passenger train operating companies (TOCs). Four freight companies were sold off, as were technological service units, the businesses that dealt with Royal Mail traffic, and European passenger services. Ownership of the track, stations, and other infrastructure was assigned to a newly formed company called Railtrack, which would subsist by charging access fees from the train operators. And in a move that was to have repercussions in the future, BR's engineering and maintenance divisions were broken up into thirteen separate companies that in turn contracted with Railtrack for their services. All of these pieces would now (theoretically) work together, not as part of a hierarchical command structure, but as a network of firms whose relationships would be governed by contracts and government regulation.

There seems to be near-universal agreement that privatization was rushed through with indecent haste. The Tories were an unpopular government with a tiny majority and believed they were going to lose the next election. Thus they raced to make privatization a fact that could not be erased by Labor.

The government feared it would have difficulty finding buyers. London's financial sector had never encountered a business like this, did not know how to value the assets, and was wary of risk. In addition, it feared that Labor would eventually renationalize. In a desperate effort to find buyers, the Tories were forced to "fatten up" the railway companies by raising subsidies. In addition, the companies were often sold at bargain-basement prices. When the true value of the pieces was recognized, those prescient enough to have gotten in on the ground floor often made vast profits.

But the most momentous decision was made with respect to the TOCs. Because potential bidders feared that competitors would descend on the most lucrative routes and skim the cream, a reluctant government was forced to abandon its goal of competition on the rails. Instead, local monopolies were awarded to train operators, undermining the very purpose for which privatization was undertaken. Even despite this concession, there were initially few bidders for the franchises.

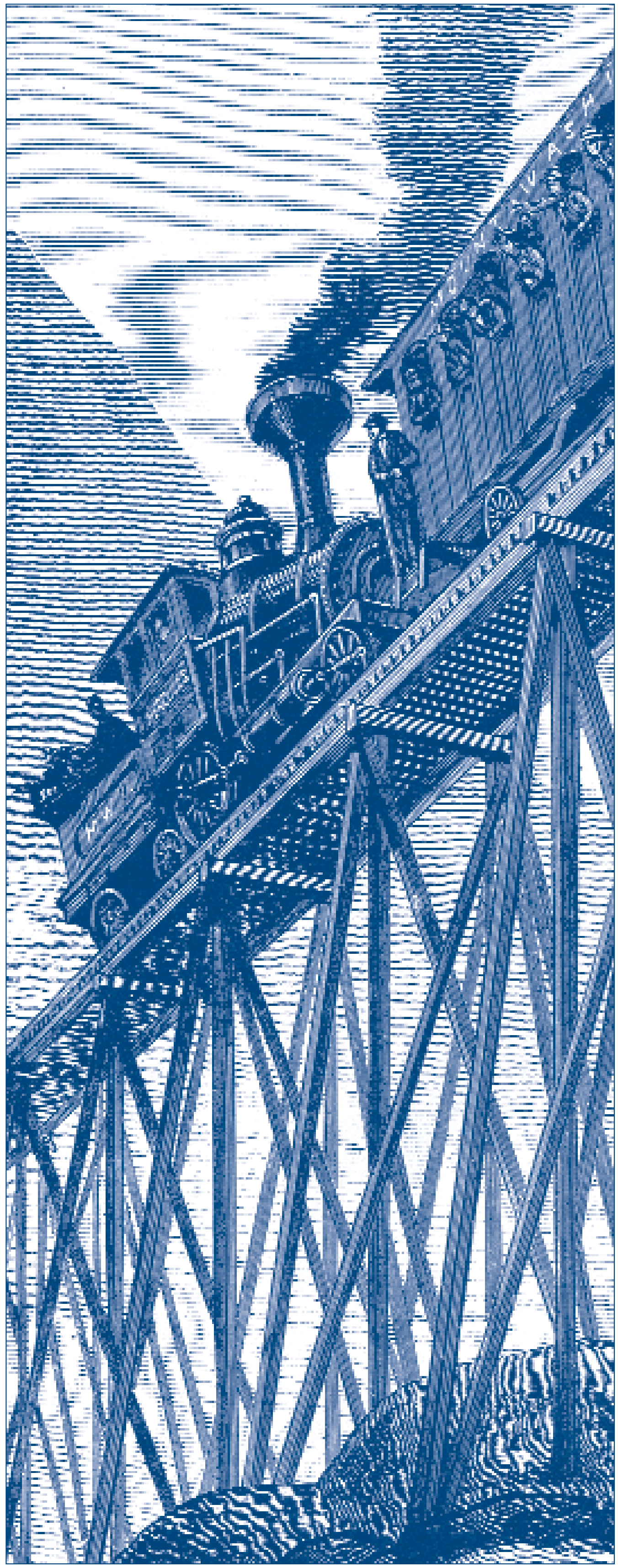
The Railtrack Debacle

The centerpiece of the system, Railtrack, was eventually offered in a public flotation in 1996. This presented the government with great difficulty. Railtrack was immense in scope (10,346 miles of track and signaling, 40,000 bridges and viaducts, 50 tunnels, 2,508 stations, 1500 signal boxes, 9000 level crossings, and 90 shops and depots). The complexity of its new, untested relationships with the other parts of the system were daunting (there were 224 separate legal agreements covering freight access alone). To overcome these obstacles and complete the sale, the government wrote off most of Railtrack's debt, set generous access fees, and offered the company at the ridiculously low share price of £3.90. The offer was seven times oversubscribed, and by 1998 Railtrack's share price was £17.68. This could be seen as a great giveaway, although given that Railtrack was forced into bankruptcy in 2001, it could be said that Railtrack's shareholders got the bad end of the deal (they eventually received around £2.50/share in compensation from the government).

Railtrack's fall was swift and total. Within just a few years, it became one of the most vilified companies in Britain. How did it plummet so far and so fast?

The early years were good ones for Railtrack, but it soon became a victim of its own success. Thanks in part to the booming economy, between 1996 and 2000 the railways experienced a thirty percent growth in usage. But trains and stations became dirty and overcrowded. There were nearly one million passenger complaints in Railtrack's first year of operation, more than ten times the level in 1983. The TOCs responded by increasing the number of trains, putting on a thousand extra services from 1997 to 1999. But this created its own problems—Railtrack calculated that for each extra one percent of service there was a 2.5 percent increase in delays. Railtrack pointed the finger for this at the operating companies. The train operators blamed Railtrack's failure to invest in new capacity.

But it was the issue of safety which above all others sank Railtrack. While there were only eight rail fatalities from 1990 to 1997, there were 38 deaths in the first three years under private management. Two bloody accidents brought Railtrack and the TOCs into disrepute, but damaging though these incidents were, it was a relatively minor third accident that more than any other factor destroyed Railtrack. On October 17, 2000, four were killed when a train derailed near the town of Hatfield due to a cracked rail that shattered into 300 pieces. This time the blame belonged squarely with Railtrack, which had known about the problem and failed to fix it.



Yet it was not the accident itself that destroyed Railtrack—it was the aftermath. Railtrack panicked. Speed limits of 20 mph were imposed at every site that showed evidence of cracking—1,286 of them. While the company's response may seem prudent, most observers agreed it was being far too cautious, as broken rails are fairly common and rarely cause fatalities. Railtrack's overreaction was undoubtedly caused by its poor understanding of engineering and its surprising lack of knowledge about the conditions of its assets (Railtrack had no catalog of what it owned).

The result of the speed limits was widespread chaos throughout the system, with massive delays, canceled services, and closed lines. Railtrack, already unpopular, sunk to new lows in the public's estimation.

The bedlam meant the end of Railtrack's financial health. Under the terms of its contracts with the TOCs, Railtrack was forced to pay compensation for the delays. In part due to these huge payments, Railtrack showed a post-Hatfield loss of £534 million compared to a profit of £360 million the previous year. Its stock price plummeted. Deeply in debt (to the tune of £3.3 billion) and with no prospect of raising funds on the capital markets, Railtrack had no choice but to return to the government, cap in hand. But patience had run out. On October 7, 2001, Transport Secretary Stephen Byers shocked the nation by putting the company into insolvency. Railtrack was eventually sold for £500 million to Network Rail, a newly formed private but nonprofit company.

The Problems of Privatization

What wrecked the privatized rail system? Those predisposed to doubt privatization in principle maintain that private gain has no place in what is essentially a public service. To them, privatization was the product of right-wing ideologues and the capital markets to whose tune they were dancing. The fact that Railtrack paid healthy dividends while protesting to the government that it lacked funds for investment and safety strikes many as the height of capitalist perfidy.

Advocates of privatization, however, can make a case that there was actually not enough capitalism involved. Both Railtrack and the TOCs were monopolies, shielded from market discipline. It could be maintained that the structure of the system never gave competition and markets a chance to operate.

The system's structure had other grave flaws. The atomization of BR created administrative chaos. When BR was dismantled, a unified, military-style command structure was replaced by a heinously complex web of contractual relationships between almost a hundred pieces of the old BR plus numerous subcontractors. Because of the uncertainty of the relationships, contracts attempted to account for all possible future situations with an elaborate system of payments and penalties. This led to an adversarial system in which the parties were frequently sniping at each other, pointing fingers, and demanding compensation.

Functions that cried out for integration were separated. First, although Railtrack owned the track, it did not own the maintenance companies. And the maintenance companies did not own the companies that actually did the repair work. Without an effective in-house engineering department, Railtrack was in no position to supervise the contractors. Thus, despite Railtrack's nominal control, the maintenance and repair companies actually called the shots.

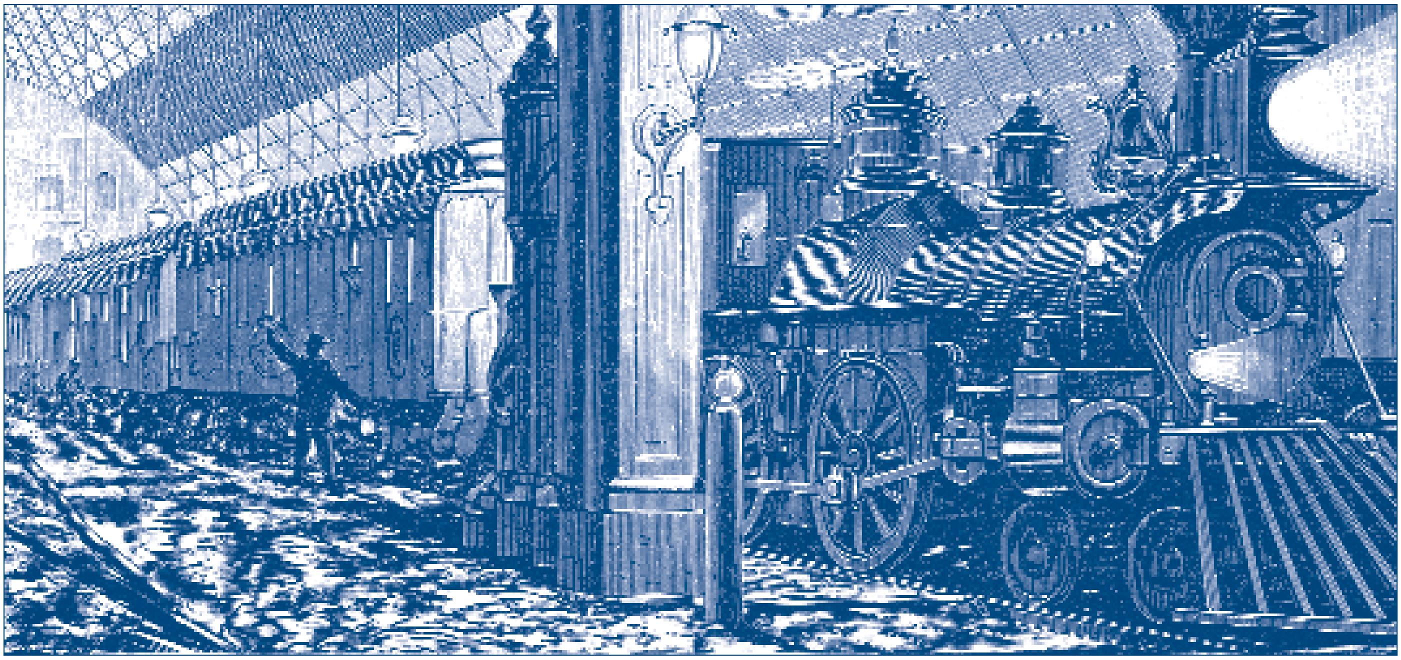
Another problem was caused by the separation of train operations from the track. Because Railtrack was required to compensate the TOCs for delays, the companies endlessly squabbled over who was to blame for them. The system for attributing fault was mind-numbingly complex and onerous, involving 1,900 checkpoints, 204 predefined delay causes, and 1,300 delay-attribution points. Railtrack employed fifty people just to account for delays in the Southern region alone. Bitter disputes and legal action ensued.

This leads to another explanation for the failure of Railtrack: perverse incentives. The TOCs had an incentive to increase service in response to the boom in traffic in the late 1990s. But since ninety percent of the access fees Railtrack charged to the TOCs were fixed, Railtrack had little interest in approving new train paths or adding additional capacity. Thus, to the consternation of the TOCs, investment in the system languished.

The problems were not limited to the private side of the equation. The role the government played in the (mis)management of the railways was considerable. A confused tangle of organizations with overlapping responsibilities oversaw the railways, including the Office of Passenger Rail Franchising, the Office of the Rail Regulator, Her Majesty's Railway Inspectorate, the British Railway Board, the Rail Passengers Council, and the Transport Secretary. Although these were supposed to complement each other, they produced duplication, paralysis, and turf battles.

Labor, which assumed power in 1997, fared little better. It took virtually all of its first term to pass any significant legislation. Eventually, Labor created yet another body, the Strategic Rail Authority, to tackle the ills of the industry. But this simply added one more layer of bureaucracy.

Plain old bad management also played a part in privatization's demise. Many of the people in important positions had



little or no experience with railways. Railtrack CEO Gerald Corbett and his successor Steven Marshall had been executives at a food and drink company prior to their association with Railtrack. Old railway hands felt their advice was ignored by newcomers who did not understand the business and had little interest in learning.

In the opinion of many, the culture of the railways, carefully nurtured under BR, was destroyed. Employees had to cope with the dismemberment of their beloved paternal organization. Widespread staff cuts bred a climate of fear and the need for many to work excessive hours. A new emphasis on cost-cutting frustrated employees, who felt the economies were irrationally conceived and operationally damaging. A great intangible—pride in their jobs and pride in the railway—deteriorated, and there was considerable nostalgia for the old organization and the sense of belonging it fostered.

Culture change, after all, was an explicit goal of privatization. In the view of privatization's supporters, the railways were a bastion of union militancy and poor public-sector work habits. Although there may be a degree of truth in this perception of the industry's ills, it cannot be denied that morale under the privatized regime suffered.

Railtrack alienated its employees, its investors, its passengers, its regulators, and just about everyone else. Its demise was thus greeted with considerable relief across Britain—it was, opined the *Economist*, like "putting down a very sick dog." But it is still worth asking: did anything go right?

In Privatization's Defense

First, it must be said there were mitigating circumstances. Many of the problems Railtrack faced were inherited. British Rail bequeathed an overbuilt system, yet for political reasons Railtrack and the TOCs were forced to continue providing service on money-losing lines. Second, the quality of the assets they inherited was often poor, as BR had been starved of capital. BR's response to rising demand had been to raise fares rather than invest or expand service. The plant was run down and lacked the most modern technology.

This raises the issue of safety. It is true that there were 42 deaths in the four years after privatization, compared with only eight in the early 1990s. But Railtrack's record was not terribly far out of line with the 75 deaths that took place in the 1980s. In fact, the total number of accidents and derailments was actually lower than it had been under BR.

Two of the major disasters were caused by drivers running through red signals, something arguably out of Railtrack's control. One could maintain that Railtrack should have installed advanced safety features which would have prevented those mishaps, but those features were clearly uneconomical. The Hatfield accident was more unequivocally the fault of Railtrack. Yet, ironically, the speed limits and the pandemonium they caused were not the result of a cavalier attitude toward safety but rather excessive concern for it.

Why did Railtrack impose such a draconian and probably unnecessary safety regimen? Perhaps the answer lies in the ,

state of the modern media. Twenty-four-hour news channels and sensationalist tabloids give greater coverage to the morbid details of train crashes than ever before. In truth, rail is a far safer mode than road travel (ten people die on Britain's roads every day), but only the rail disasters attract the public's intensive scrutiny. For this reason, Railtrack simply could not afford another crash.

Moreover, Railtrack faced the public's suspicion on account of its being a private company. Undoubtedly, in the eyes of many, these accidents (as well as the delays, dilapidation, and crowding) were the result of penny-pinching and greed run amok. The public was deeply skeptical about the very notion of a public service being run for private profit, and thus the tenor and volume of the criticism Railtrack faced were perhaps to an extent unwarranted.

There are some aspects in which the privatized railroad succeeded. From 1997 to 2002 the number of passengers increased by twenty percent and distance traveled by thirty percent. At least part of the credit should rest with the TOCs. First, they ran more trains, which BR was loath to do. This may be seen as a case of privatization delivering on the promise of more efficient and effective employment of the system's assets. Another success was improved marketing. In some respects, the rail system did indeed become more customer-friendly.

In addition, the privatization period was not without new investment, and there were cost savings and a slimmed-down labor force, although many (particularly in organized labor) consider this a black mark for Railtrack, not a badge of honor.

Fallout

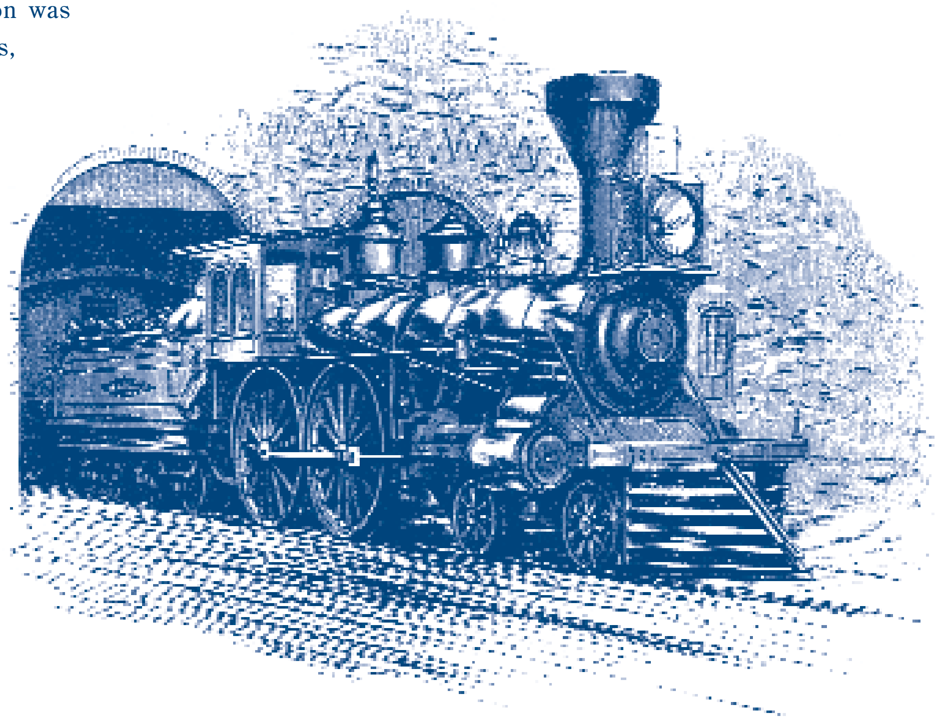
The final argument on privatization's behalf is the record of its successor. Network Rail is run by a not-for-profit corporation with an extremely unwieldy governance structure. Critics generally agree that it is merely a front for what is, in essence, renationalization. The prime advantage of the current system, at least as far as the government is concerned, seems to be that Network Rail's debts are kept off the public balance sheet. And given the levels those debts would reach, the government seems to have made a wise decision.

Disorganization reigned in the months after the transition. Delays rose and Railtrack staff deserted in droves. The system desperately needed private finance, but not surprisingly it proved difficult to raise capital. The Network Rail structure was hastily cobbled together with a speed that makes Railtrack seem the product of careful deliberation.

By 2002 passenger numbers and revenue were beginning to fall for the first time since privatization. Delays were worse than they had been under Railtrack. Almost one-third of the TOCs were in need of a bailout. At the same time, thanks to questionable management, Network Rail's already huge deficit continued to swell. To stem the tide of red ink, an unpopular across-the-board fare hike was instituted. Recently, the system has improved in terms of ridership, performance and reliability, but only at the cost of ever-rising subsidies (from £1.4 billion in the year before Hatfield to £4.6 billion per year today).

Thus a final point should be made in privatization's defense. The railways did not work particularly well before nationalization or under BR. Privatization was judged a failure, but by many measures, creeping renationalization has been worse. In sum, no administrative system has ever proven totally satisfactory. Perhaps the conflicting goals of profit maximization (or, as is more usually the case, loss minimization) and the provision of a social service are to a degree unreconcilable.

Over the last ten years, British politicians of both parties have not done the rail system any favors. Perhaps they are taking revenge on the railways for the death of poor William Huskisson. u



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