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Whither the Railways?

A Comment on *Phoenix from the Ashes* by
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The failure to deliver the performance on the railways which its customers demand has led to a host of proposals for reform. These are often self-interested, and range from the re-nationalisation and re-monopolisation of the industry, through to more evolutionary measures, designed to fine-tune the structure put in place at privatisation.

Among the radical proposals, there is little by way of explanation as to how in practice the rewriting of the industry will deliver better performance. Almost all such proposals involve re-integration, either with track and train services being merged into a series of vertically integrated regional companies, or complete re-integration into a new British Railways.

It is worth rehearsing why both of these re-integration proposals are flawed. The regional monopolies would not *solve* the coordination problem, and, indeed, in British Railways' day the ownership integration reduced the need to expose and address the costs which contracts have made transparent.

Integration through contract may have higher transaction costs, but it has the benefit of transparency and clarity of responsibility. The fact that at least one of the parties—Railtrack—has failed to perform satisfactorily does not mean that it would be sensible to disguise the evidence in future. The contractual approach has also placed the responsibility for the provision of customer services with the train operating companies (TOCs), and in doing so exposed their managerial weaknesses.

The most significant problem with the regional monopoly model is that it does not provide for the coordination of the *national* railway network—indeed (as with electricity before the grid was created), regional monopolists have little incentive to open up their networks to rivals, or to recognise where the good of the network as a whole should override their own narrower regional interests. By breaking up Railtrack into regions, a very significant system-wide perspective would be lost.

It is tempting to suggest that this problem would be overcome by going the whole hog—to a single monopoly in the BR mould. While there are some arguments in favour of such structures, it is also important to remember some of the less attractive features of BR, and in particular the twin difficulties that there is even less ability to cope with management failures; and that the power of the unions is increased.

Nationalisation, as a means to full integration, would be unlikely to add much benefit. Indeed, state ownership would expose the industry to a blurring of responsibility and control, and leave investment in the hands of the Treasury. A *ten*-year plan would be unlikely in a nationalised industry, and to the extent that private ownership means that the government must *contract* with the private sector, there are obvious benefits in forcing contracts rather than promises from the Treasury.

Evolution, then, is much to be preferred, and, again, a host of suggestions have been made. Chris Green's evolution is basically managerial. He proposes three changes—industry leadership in the form of a Rail Senate; the streamlining of organisation, which in practice means consolidation; and professional delivery. None of these is particularly novel, and it would be very surprising if these measures would in themselves make more than a marginal difference.

An evolution needs more than tinkering if it is to meet the scale of the problems, and the sorts of changes that are needed relate to the core functions of the railway industry: the overall management and enhancement of the network; the regulatory framework; and the incentive structure facing Railtrack and the TOCs.

In every *national* network, the interests of the network *as a whole* are more than the sum of the interests of the individual companies. The network has to be glued together, with the coordination of the network monopoly performed at the centre. This is the lesson of a century of national infrastructure history—including electricity's national grid, the gas industry's national transmission network, and in the post-war years, the telecoms network. Railways display the coordination problem *par excellence*.

This function was to be carried out by Railtrack, but with the Integrated Transport Strategy it has increasingly transferred to the Strategic Rail Authority (SRA), although there remains less than perfect clarity about the location of the core responsibility. The uncertainty is further confused by the role of the Office of the Rail Regulator (ORR) in agreeing CAPEX with Railtrack for the setting of the Track Access Charges.

The role of ORR with respect to the SRA needs clarifying, in its wider industry responsibilities. Elsewhere, I have argued that the two bodies should be merged (Helm, 2001), and the model which might profitably be followed is that of the Economic Regulation Group with the Civil Aviation Authority. Not only would this bring the CAPEX side of Railtrack's regulation together under one roof, but also ORR's regulatory skills will be helpful in overseeing the longer-term franchises being let by the SRA.

The incentives on the main companies—Railtrack and the TOCs—also need to be addressed. The SRA proposals for Special Project Vehicles to tackle enhancements raise questions about the allocation of the functions of financing investment and carrying it out. As long as Railtrack has a regulatory asset base into which new investments are incorporated, it will continue to have the core financing function. But the inclusion of new CAPEX carried out by others at a fixed *ex-ante* price is very different in incentive terms to an *ex-post* cost pass-through. There are arguments in both directions on risk allocation, but the primary need is to clarify who bears the risk, and therefore how the incentives are assigned.

These evolutionary changes are more demanding than those proposed by Chris Green, but not inconsistent with them. Until the roles of the key players are clarified, there is unlikely to be much by way of a renaissance of the railway industry.

Reference: Helm D.R. (2001), *A Critique of Rail Regulation*, IEA, Beesley Lecture.