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Critical Perspectives on Accounting xxx (2017) xxx–xxx

Contents lists available at ScienceDirect

Critical Perspectives on Accounting

journal homepage: www.elsevier.com/locate/cpa

'A Very Costly Industry': The cost of Britain's privatised railway

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ARTICLE INFO

Article history:
Received 11 March 2016
Received in revised form 5 March 2017
Accepted 21 April 2017
Available online xxx

Keywords:
Critical public interest
Privatisation
British
Railways
Costs

ABSTRACT

This paper is concerned with the financial performance of the British passenger rail industry since privatisation in the mid-1990s. This experiment, which not merely transferred a state-owned and fully integrated industry into the private sector, but dismantled it into over 100 separate entities, has generated considerable and highly critical academic literature. A major contention of this literature is that, contrary to the predictions of its proponents, privatisation has largely failed to improve efficiency and has actually increased costs, or more exactly, costs are higher than they would have been, had privatisation not taken place.

However, although various writers have put forward diverse arguments to support this position, robust data on the overall costs of the (now highly fragmented) industry have been lacking. Further, a proper assessment of the additional costs (or otherwise) of privatisation can only be made in light of 'counterfactual' estimates (necessarily speculative) of the costs of the state-run industry if privatisation had not occurred.

This paper aims to fill this literature gap by: (1) constructing a robust series of the overall operating costs of British passenger rail services since privatisation, (2) projecting, using reasonable assumptions, what operating costs would have been if privatisation not taken place, and (3) estimating the increase in such costs arising since privatisation.

The results, whilst they can only be broadly indicative, are nevertheless clear. Even after conservative assumptions, rail privatisation has resulted in considerable additional costs: it was a major public policy error.

'There is a mystery, is there not? We look at the net figures and it is £5bn going into the railways this year and everybody tells us their part of the system is ever more efficient and effective, yet the bottom line is £5bn.'
Graham Stringer, MP, member of the House of Commons Transport Select Committee (TSC), 12 July 2006 (TSC, 2006, Q198).

1. Introduction

This paper is concerned with the financial performance of the British passenger rail industry since it was privatised in the mid-1990s. This privatisation has generated a considerable academic literature, much of it highly critical. Proponents of privatisation predicted it would lead to greater efficiency, more responsiveness to passenger needs, and the elimination of state subsidy and direction. Many critics have argued that it has comprehensively failed to deliver, instead producing a

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http://dx.doi.org/10.1016/j.cpa.2017.04.002

Please cite this article in press as: S. McCartney, J. Stittle, 'A Very Costly Industry': The cost of Britain's privatised railway, Crit Perspect Account (2017), http://dx.doi.org/10.1016/j.cpa.2017.04.002

structurally fragmented, operationally complex and financially dysfunctional industry. For example, state financial support, forecast to disappear as premium payments made by franchisees on profitable lines outweighed subsidies elsewhere (Crompton & Jupe, 2003a; p. 399), has actually grown from £2.93bn in 1994/95 to £5.28bn in 2013/14 (at 2013/14 prices – see ORR (2015a)). And, some critics argue, the major beneficiaries of this largesse 'are not the passengers but the owners of the rail companies and the providers of capital [so that] as in all previous sales of state-owned industries, rail privatisation has been used to transfer wealth from the public to the private sector' (Jupe & Crompton, 2006; p. 1062).

A major contention of the critical literature (reviewed below in Section 3) is that privatisation has failed to improve efficiency and has actually increased costs, or more exactly, costs are higher than they would have been, had privatisation not taken place.

However, although various writers have put forward diverse arguments to support this position, robust data on the overall costs of the (now highly fragmented) industry have been lacking. Further, a proper assessment of the additional costs (or otherwise) of privatisation can only be made in light of detailed 'counterfactual' estimates (necessarily speculative) of the costs of the state-run industry if privatisation had not taken place, which as far as the authors are aware, has not been attempted until now.

This paper aims to shed light on this issue by:

1. Deriving robust data, from publicly available sources, on the overall operating costs of British passenger rail services, both before and after privatisation, so that the way in which these costs have varied over time (and in relation to the volume of traffic) can be more clearly understood;
2. Projecting, with reasonable assumptions, what these operating costs would have been had privatisation not taken place; and so
3. Producing a reasonable estimate of the increase or decrease in such costs resulting from privatisation.

The paper now proceeds as follows: Section 2 provides a brief outline of the background to privatisation, the restructuring of the railways this involved, and the major actors in the post-privatisation industry; Section 3 provides a review of the literature, concentrating on that which has argued that railway privatisation has led to increased costs; Section 4 gives an analysis of the operating costs of privatised passenger services compared with the counterfactual outcome if the state-owned British Rail had been operating these services. Finally, Section 5 provides some conclusions.

2. The context

2.1. A problematic privatisation

The railways possess 'several unique features' which made privatisation particularly problematic. Although regarded as a 'natural monopoly' due to 'the fixed costs of the network and the strength of the case for unified operation and vertical integration', the railway industry was in a 'competitive transport market' and in decline, losing market share to road and air (Crompton & Jupe, 2003a; p. 398).

In particular, the industry has very high fixed costs: about half of all operating costs relate to the infrastructure (track, signalling and stations) varying little with the volume of traffic. This is also true of utilities such as gas or electricity, but whereas the latter 'provide an (almost) universal and essential service' (Shaoul, 2004; p. 30) and so can 'spread fixed costs across many users', in contrast, rail passenger services are 'not universal and unavoidable', and in the absence of adequate demand cannot fully recover these costs (Crompton & Jupe, 2003a). Full recovery from passengers would entail self-defeating fare increases that would 'choke off demand', inflict economic and social damage and be 'politically unacceptable.' Closure of subsidy-dependent lines would also have political and social consequences (Shaoul, 2002; p. 53).

As a result, although the transfer of state-owned companies and utilities to the private sector was a defining feature of the 1979–97 Conservative administrations, there were initially grave reservations about privatising the railways.

Margaret Thatcher (Prime Minister 1979–90) was particularly mindful of 'the huge political risks' and 'nervous of the public reaction' (Parker, 2012; p. 449).

In the 1980s HM Treasury also showed a marked reluctance to embrace rail privatisation. The industry was regarded as a 'large and complex system with many joint costs and interdependence of different services [which could not] be easily broken down into separate elements'. Many lines could not be profitable, but would have to be subsidised for social reasons, rendering privatisation difficult if not infeasible (Parker, 2012, pp. 445–6).

When a commitment to privatise the railways was finally made by the Major government (in the Conservatives' Election Manifesto in 1992) these problems were simply ignored. The subsequent White Paper, a slim document of 21 pages 'rather lightweight' on the economic rationale behind the privatisation plans (Preston, 1996; p. 2) blandly asserted that a privatised industry would 'mean more competition, greater efficiency and a wider choice of services more closely tailored to what customers want' and 'provide greater opportunities to . . . reduce costs, without sacrificing quality' (Department of Transport (DoT), 1992; pp. 1, 5). But evidence to support these assertions was distinctly lacking (Jupe & Crompton, 2006; p. 1037).

Apart from a general predisposition to assume that 'private' must mean better, the government had a number of objectives in privatising the railways: to eliminate or at least reduce public subsidy; to raise money from the sale of assets (Crompton & Jupe, 2003a; p. 399); to transfer decision-making and risk to the private sector (Transport Select Committee