Tunnel Vision: The Privatisation of the London Underground

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In a time of fervent debate as to the future of the London Underground, Susannah McAleese investigates the options which exist for New Labour. She weighs up arguments for and against privatisation, continued public ownership, and the proposed 'Public-Private Partnership' that New Labour has in mind. By way of conclusion she argues that privatisation is the most desirable way to improve both investment and efficiency.

Introduction

London Underground is a major business with 3 million passenger journeys a day, nearly 500 trains serving over 260 stations, around 16,000 staff and vast engineering assets. London Underground Ltd. (LUL), a wholly owned subsidiary of London Regional Transport (LRT), a nationalised industry, operates the Underground. The company was formed in 1985, but its history dates back to 1863 when the world's first Underground railway opened in London.

The Underground began life as a privatised company when Metropolitan Railways opened the first railway between Paddington and Farringdon Street. In 1933, the privatised company had become the London Passenger Transport Board. This was placed under government control as an emergency measure during the 1939-1945 war and was officially nationalised to become the London Transport Executive, part of the British Transport Commission, which also controlled British Railways, docks, canals, airlines, and road freight.

There is a feeling that while London may once have enjoyed a highly efficient transport system, this is no longer the case. Passengers complain about long delays, frequent stoppages and overcrowded carriages, and a sense of low staff morale. Behind all the problems lie deeper structural flaws in the management of the Underground. Unless radical changes are made, the position will continue to worsen.

One obvious solution is to involve the private sector. This involvement could take many forms. Privatisation has worked successfully in several sectors of the British economy such as telecommunications, airlines, and electricity. However, in the case of British Rail, privatisation has, according to The Economist[1], proved "*a disastrous failure*" (for reasons we discuss later). Given the similarities between underground and overground rail this raises the question of how to achieve a successful outcome in the case of London Underground and avoid the mistakes of the British Rail privatisation. A successful outcome is possible. There are many examples of privatisation of railways from Argentina to Hong Kong, and from India to Canada. Indeed, the UK has seen successful privatisations in other sectors of the economy.

> "*The privatisation of British Airways has unquestionably improved its productivity vis-à-vis nationally owned European rivals. Equally, the privatised UK bus companies have increased productivity.*"[2]

Finding the solution requires an understanding both of the economics of transport and of business organisation, as we shall see. This paper is divided into four sections. First, we describe the current privatisation proposal. Second, we look at the case for privatisation. Third, we consider the arguments against privatisation, before finally setting out a set of options.

Privatisation Plan

Prior to the May 1997 election, Britain's Conservative government promised to privatise the London Underground[3]. The main reason used to justify the privatisation was that it would help to provide the money needed to bring the Underground up to date. However, with the arrival of New Labour in government, the idea of privatisation was set aside but has now returned to the limelight. It is, however, in partnership between the private and public sectors where most potential lies.[4]

Public-Private Partnership (PPP)

Privatisation has emerged in another guise in the form of PPP (Public-Private Partnership). PPP is the term that New Labour has adopted for its privatisation of the Underground. Its main objective is to increase investment and to improve efficiency in the system. Under the new arrangement, announced by the Government in March 1998, London Underground's operations will remain in the public sector, but the

[1] The Economist (3/7/99)
[2] Button (1993)
[3] Munro (1998)
[4] Andersen, Bannister & Barrett (1995)

private sector will take over responsibility for maintaining and improving its infrastructure.[5] The intention is to divide London Underground into a publicly owned operating company and three privately-owned infrastructure companies (InfraCos) which will be contracted to maintain and enhance the infrastructure. The three infrastructure companies will be known as Infraco JNP (Jubilee, Northern, and Picadilly lines) and Infraco BCV (Bakerloo, Central, and Victoria lines), and Infraco S-SL (Sub-Surface lines).

The PPP will also see an end to annual spending limits. Management will be able to plan for the future knowing that the private partners will contribute the cash necessary to see these plans through. The PPP process offers bidders a secure revenue stream for 25-30 years, a sensible allocation of risk, freedom and incentives to deliver and improve performance in the way they see fit.

However, the Government needs to ensure that PPP is an attractive partnership to the private sector. After all, the London Underground is more of a liability than an asset. The Government cannot expect private investors to provide the basic funding required.[6] Andersen, Bannister, and Barrett (1995) suggest ways of facilitating interest from the private sector. The Government could raise capital through: loans from the European Investment Bank, the Regional Development Funds and the new European Investment Fund; tax incentives to the private sector by making their capital contributions tax deductible; and employment taxes.

The Case for Privatisation

The Exchequer is the principal source of funds for the London Underground. However, the history of Exchequer funding has demonstrated that the Underground does not generally carry enough political weight in the national spending process to deliver adequate and consistent funding.

The existing Underground business makes an operating profit of about £200 million a year. The forecasted profit for 1999/2000 is approximately £290 million. This is not enough to cover the capital spending of about £350 million a year needed to replace equipment as it wears out. In addition there is a backlog of investment

[5] London Transport Annual Report (1999)
[6] Glaister & Travers (1995)

required to bring the Underground up to a reliable, working standard. This investment is estimated to cost about £1200 million at today's prices.[7]
The problem is that successive UK governments have been unwilling to provide extra funds to the London Underground because of the fear that such funds will be used inefficiently. By starving the Underground of investment, the system became inefficient and the prophecy became self-fulfilling. A vicious circle develops of under-investment leading to inefficiency and inefficiency itself then further deterring investment. The first argument for privatisation therefore is that it provides a way out of this impasse. Given the right circumstances, private ownership will secure both more efficiency and more investment at the same time.

A second reason for privatisation is popular demand for change. The quality of life for Underground users is significantly affected by their experiences on the Underground. The delivery of the service provided by London Underground is widely acknowledged to be very poor. A survey carried out in March 1996 gives some idea of the scale of the problem (see Table 1). While this is an illustration of just one railway network, 74 delays on the Central line in one month does seem terribly high.

Table 1: Delays on the various lines of the London Underground, March 1996. Available from: http://www.daisy.co.uk/template/delays.html

Line	*North-ern*	*Central*	*Jubilee*	*Baker-loo*	*District*	*Pic'dilly*	*Victoria*	*Metrop-olitan*
No. of delays	38	74	27	62	29	27	14	11

A third problem with the present system concerns incentives and organisation: the lack of clear methods of measuring performance, the assignment of multiple goals which often conflict, lack of incentives to minimise costs, and vulnerability to political interference. These are standard problems encountered in nationalised industries. We briefly comment on how they have impacted on the Underground.

Being a nationalised company, the London Underground is not subject to take-overs or the risk of bankruptcy. Consequently, it is exposed to less scrutiny by the financial markets than their private-sector counterparts.

[7] Glaister & Travers (1997)

The London Underground has been assigned multiple goals such as: the delivery of a high quality standard service, the delivery of a community service obligation, and cost minimisation. These goals often conflict. For example, the London Underground needs to charge a higher fare to maintain the railway network yet it cannot because it is obliged to provide transport to the public at a '*reasonable'* price. Firms in the private sector have fewer problems of this nature. A clear profit objective is usually specified.

The Government's willingness to meet the costs of '*social objectives'* means that the incentive to minimise these costs is reduced. Trade union pressures to protect employment compound this problem. Consequently, productive efficiency is not achieved. A private company has a much stronger incentive to search for gains in productive efficiency and improvements in responsiveness to consumer demands.

Regardless of how clear managerial objectives are, efficiency cannot be achieved unless managers are given the authority to make the key decisions required. Political interference often inhibits managerial innovation and reduces accountability. This is perhaps one of the strongest arguments for privatisation of industries in general. It is a particularly acute problem in the case of the London Underground. This is because the large absolute amount of subsidy required invites political attention. It obtains about £500 million of public money each year and will require even more for the next 10 years. These large figures make it only natural for Parliament to take a close interest.

The Government has requested that the London Underground should operate in a 'commercial' way, yet politicians intervene in almost every aspect of its activities. Examples of such interventions include the setting of fare levels, investment totals, new safety requirements and, most importantly, the requirement that the 'public service' obligations of the network should remain virtually unchanged. This last demand, taken with consistently inadequate investment and limitations on fare rises, demonstrates the fundamental weaknesses of the political framework within which the Underground is obliged to operate.

PPP is designed to address these deficiencies in the London Underground. It is intended to help overcome the investment backlog and to upgrade the assets, at an estimated cost of £7 billion over 15 years. In the past, the public sector has been the main contributor, but with the increasing costs of new transport projects and with the desire of governments to reduce public deficits, new sources of capital are required.[8] Privatisation will also help eliminate the uncertainty associated with the reliance on government funding.

Arguments against Externalities

One standard difficulty stems from what economists call ‘externalities’.[9] These arise when an economic activity affects a third party who had no say in the effect-creating action. They usually occur when a market system is left to operate freely. Underground rail systems have marked effects on other areas of economic activity. An increase in Underground fares, for instance, causes some passengers to swap the train for their cars. That increases congestion in the streets, thus increasing noise and air pollution, imposing additional costs on everyone else. None of this would be taken into account if private companies were free to set train fares and timetables. [10] Secondly, the huge costs of building new urban rail networks make competition among rail systems unlikely.[11] Whoever buys London’s Underground network, for instance, will need to invest an estimated £1.2 billion immediately to cover essential repairs and maintenance. The London Underground is a natural monopoly in the sense that a single firm can supply the service to the entire market at a lower cost than could two or more firms. The privatisation of a natural monopoly, such as the London Underground, would result in a non-competitive market continuing to exist. Buses and other over-ground systems of transport provide some competition, but many commuters have no practical alternative to the Underground. Therefore the normal competitive pressures that keep prices in check are missing. This last consideration, in particular, constitutes the main argument against outright privatisation of the London Underground. As the UK Government also runs other forms of urban transport aside from the London Underground, the whole system can be managed as a single operation, with a co-ordinated fare structure and common tickets covering buses and urban trains.

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[8] Andersen, Bannister & Barrett (1995)

[9] The Economist (22/3/97)

[10] Available from http://www.mtrcorp.com. Too much can be made of this externalities argument. Hong Kong’s privatised MTRC, for example, increased fares by 7.5 % per annum since 1979 (lower than the average increase in the Consumer Price Index of 8.3% during the same period). Even though the average fare increase is lower than inflation, the MTRC still manages to remain efficient.

[11] The Economist (22/3/97)

The adverse experience of British Rail has affected perspectives and is the third factor to be considered when arguing against privatisation. The sale of British Rail in 1996 has been associated with managerial incompetence and financial opportunism. "It has cost taxpayers billions of pounds and brought rail travellers countless hours of delays".[12]

The new private owners have been accused of caring about profit more than safety and the general efficient operation of the trains. The recent Paddington train crash in October 1999 has been cited as an example of this. British rail was split into four components, each component being sold to separate operators. The problem is that the duties of these operators are often conflicting. For example, Railtrack, which owns the track and railway stations, has to pay the train operators (among them Virgin Rail and Great Western), if trains are delayed because of track problems. To minimise these penalties, there is an incentive for Railtrack to reduce expansion of the number of tracks available.

Three options for the Government

There are three main approaches to the privatisation of the London Underground.

Option 1

Preserve the current arrangements but insist on minor changes.

Many prominent figures, including certain New Labour politicians and Ken Livingstone, a candidate in the Mayor of London election, remain opposed to the idea of privatisation and believe that the Underground should remain nationalised but with minor changes. They suggest that finance could be obtained through a bond issue, and ways could be found to improve management through better remuneration and more targeted incentives. Independence of the organisation from government interference could also be established (as has been the case of the Bank of England). They argue that many underground transport systems in public-sector ownership, such as the Paris Metro, provide a good service and value for money.

Option 2

'Sell' the Underground as a single, unified business. [13]

This would involve creating a franchise for a defined term, defining the investment requirements and/or service quality standards and providing a lump sum or a

[12] The Economist (3/7/99)

[13] Glaister & Travers (1997)

guaranteed annual cash flow subsidy. This is essentially the model adopted in the city of Buenos Aires, apparently with some success.

Buenos Aires: Case Study[14]

Metrovias S.A. is a private company that operates a broad public transport network in the city of Buenos Aires, which is comprised of five Subway lines, the Premetro Line (a light rail line) and the Urquiza Line (a suburban railroad line).

In 1990 the metropolitan railroad system was about to collapse. The lack of investment and equipment maintenance brought about degraded services and a decrease in demand that was less than half as compared with that of 30 years before. Facing this reality, in 1991 the Government invited private consortia to take over the operation.

The bidding process took place with the support of the World Bank, which provided financial and technical assistance to the Argentine Government. By the end of 1991 the bid conditions for the different groups were published. The winning consortium formed the company Metrovias S.A. and took over the service in 1994.

Metrovias undertook to transform the network into an efficient and profitable operation. Through competitive, modern management, Metrovias has succeeded in effecting a marked improvement in urban transport. Vehicle congestion as well as the environment pollution in Buenos Aires has fallen as a result.

Option 3

Creating about ten line-based, integrated franchises. [15]

Franchising gives opportunities for efficiency gains without the Government having to give up public control of the London Underground.

> "*The use of various forms of franchising will be an effective means of solving the need for further efficiency measures in public transport operations without choosing the most radical alternative – full deregulation. This allows politicians to take 'social effectiveness' into*

[14] Available from http://www.metrovias.com.ar

[15] Glaister & Travers (1997)

> *account, and at the same time reduce the pressure on public budgets*."[16]

Advantages of having several operating companies

a) Yardstick competition:
There will have to be some system of economic regulation by the public sector, either through central government or an independent regulator. It will be one of the responsibilities of this body to disburse the public funds to the operator(s). This task is made easier if the body can compare and contrast a number of operators, as opposed to just one, in areas such as cost efficiency and quality of services.

b) Several companies will be of a more manageable size (financially and geographically) than a single company. The London Underground is a large, complex and geographically dispersed business, which adds to the difficulties inherent in managing it.

c) A market system for corporate control can be a useful discipline to enforce efficiency.

d) Industrial relations may be easier to manage in several, smaller businesses. Employees in a large business like the London Underground may feel as if their opinions go unheard, which often leads to trade union intervention. In a smaller business, it is less likely that trade unions will be called to intervene.

Disadvantages of Having Several Operating Companies

a) The attribution of revenues from Travelcards and similar travel-saving tickets to the respective commercial operators is one area of difficulty. On what basis will these revenues be allocated? Buses presently get over this problem on the basis of survey evidence on patterns of usage. In the long term, if many operators are involved in the Underground, more sophisticated use of electronics will allow a more precise allocation of revenues.

b) Another obvious disadvantage is that many operators will be sharing tracks and other shared facilities. This could lead to severe disruption. Avoidance of this problem will require careful regulation.

[16] Andersen (1995)

Conclusion

In the pre-1939 period the London Underground was widely admired. Since nationalisation things have started to go awry. A spiral of decline has set in for reasons explained in this paper. Hence the need, indeed the urgency, to consider the case for 're-privatisation'.

Politicians, civil servants, and other members of the London community reiterate the importance of an efficient and reliable public transport system. Regularly this has proven an elusive objective because of chronic under-investment as well as the interference by the government in the areas of fare levels and infrastructure. The Underground's management has found it difficult to achieve efficiency. As a result, the present system falls short of millions of Londoners' reasonable expectations. As Stevens says:

> *"the property rights theory of the firm suggests that public enterprises should perform less efficiently and less profitability than private enterprises. In a private enterprise, both internal control – via the shareholders – and external control – through the discipline of the capital market – provide incentives to avoid inefficiencies. By contrast, public enterprises are not subject to the discipline of the capital markets, and internal monitoring is conducted by politicians who do not necessarily see their role as supervising the efficiency with which managers allocate resources."* [17]

However, privatisation will not solve all of the problems. The case of British Rail demonstrates this. But some degree of privatisation could make a major improvement especially in terms of funding and motivation. There is a need to take special account of the presence of externalities and lack of competitive markets in deciding on the form of privatisation.

The Government will be using PPP, that is, effectively, the third option, in that it plans to create franchises to be sold to the private sector. Yet, privatisation is by no means easy. It will require the establishment of good regulatory policy to avoid possible problems such as excessively high fares. Despite these hurdles, the London

[17] Stevens (1992)

Underground needs to be re-vitalised and privatisation appears to be a positive and solid way to do this.

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