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## **The Politics of Divestment: Passing the Buck along the Railway Line**



Everard Smith



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# **The Politics of Divestment: Passing the Buck along the Railway Line**

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## *Abstract*

Rising public expectations together with ageing public services infrastructure have led many governments to embrace privatisation as a pathway towards higher quality public services at lower costs. The story that surrounds the mid-1990s divestment of British Rail is one such example. But, making the transition to this win-win objective is neither easy nor certain. By examining how ‘official’ discourse has been used to place the blame for Railtrack’s failure to deliver improved rail services upon shareholders, this article shows that privatisation also provides governments with a powerful political alibi when public policy goes wrong.

## **1. 0: Introduction**

Finding the right balance between services that should be provided by the state and those best provided by the private sector has long foxed governments and public administrators. Since the late 1980s, however, governments in many developed and developing countries have demonstrated a great fondness for a progressively deeper involvement of the private sector in the provision of a range of public services. Led, in large part, by the political and economic doctrines of Thatcherism in the UK and Reaganomics in the US, the movement toward privatisation continues to be viewed as an effective response to issues of growing public demand for high quality public services, which, under direct state management, have been deemed to be of low quality, expensive and slow to react to changing consumer demands. This politico-economic stimulus toward privatisation seems, therefore, to 'rest on the traditional distinction between private and public efficiency and on the delineation of the private and public sectors' (Genoud and Varone 2002, p. 23).

If the of variance in the capacity for efficiency between the private and public sectors is explored, three dominant arguments emerge. The first holds that the goals of profit and augmentation of the bottom-line tend to drive private companies toward high levels of efficiency (see Cohen 2001, Genoud and Varone 2002, Li and Xu 2002. Greene 1996, cited in Cohen 2002, for instance, suggests that

inefficiency is an inherent characteristic of municipal bureaucracies because of the incentive structures that encourage empire building and overproduction (Cohen 2002, p. 433).

It follows therefore, that to the extent that private companies can be encouraged to become involved in the delivery of public services is the more efficient and cost effective those services will be.

The second argument sees the open market context within which private companies usually compete for market share and resources as constituting a powerful driver for efficiency in contrast to the organisational waste and inefficiency that has come to be associated with state monopoly service providers. Within this scenario, the desire to survive encourages private companies to develop the capacity to react more nimbly to changing consumer needs, thereby ensuring the optimum exploitation of their productive resources.

The third argument, and the one, perhaps, most easily communicated to the public, is that some public services are more efficiently and effectively provided by the state whilst others are best delivered by the private sector. Education and state security are two examples of services that are deemed to be best provided by the state, whilst, in the case of the UK, the provision of public transportation is considered (by government at least) best placed in the hands of the private sector.

These three political arguments are clearly not mutually exclusive. They coalesce to provide powerful justification for reducing the size of the administrative state. Of course, this paradigm shift in how public services are delivered in many countries have not gone without engendering widespread public concern and, in many cases, strong opposition from consumer and labour interest groups as well as politicians in opposition. However, for the most part, these dissenting voices tend to be quietened

by government pledges to ensure that systems of accountability and transparency will be instituted and rigorously applied whenever services formerly provided by the state are placed in private hands.

Drawing on the post-divestment experience of British railways, this paper aims to illustrate that, in addition to the notion of greater efficiency in the use of resources and in the delivery of public services that private sector involvement brings, divestment also provides governments with a powerful political alibi should things (continue to) go wrong. In making this point, the paper examines how official discourse has been used to shift the blame for the poor performance of the Railtrack component of the British railways divestment, squarely onto shareholders. In doing so, the paper uses information gathered through an extensive literature review as well as the results from empirical analyses of secondary data.

## **2.0: Privatisation of British railways**

In the UK, as in many other countries, privatization of public services has been one of the most politically sensitive public policy undertakings. Despite the assumption of positive outcomes (see above), the provision of public services through private sector ownership and management sometimes present significant negative consequences. These negative impacts, such as labour dislocations and social responsibility breaches, are often masked or go undetected as, in the main, positive outcomes tend to be measured in efficiency and economic terms. As a result, a range of voices continues to caution against the use of easy assumptions to underpin government's privatization policy.

In the case of Britain, and the mid-1990s divestment of British railways, Godward (1998) reminds us that the control of Britain's railways by the private sector is not a new phenomenon.

Until 1923, Britain's railways were controlled by more than 120 companies. After 1923 the companies were rationalized into four major companies on a geographical basis. This situation lasted until 1947 when the companies were nationalized by the Government to create British Railways (Godward 1998, p. 191).

During the late 1980s, the Conservative government were in-search of suitable approaches to minimise the burden that subsidy to British Rail placed upon public funds (Godward 1998, Haubrich 2001), as well as ways to generally improve rail services. Seeing competition as the most effective way of achieving improvements in services, the government embraced privatization as the way forward (Watson 2001). Hence, the railway structure that was settled upon and implemented between 1994 and 1997 saw the splitting of British Rail into two spheres of activities: operations and infrastructure. Broadly speaking, railway operations (freight and passenger services) were packaged and sold as franchises to different *subsidy bidders*.<sup>1</sup> The objective being to sell each package to the bidder with a good business plan that required the lowest level of public subsidy.

Management of the railway infrastructure was vested in a government-owned company called Railtrack, with responsibility for maintenance, renewal and operation. This rather benign remit of the government-owned Railtrack masked what Godward argues was the key purpose of the company: 'to generate profits from owning, developing and maintaining Britain's rail infrastructure' (1998, p. 194). Godward's

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<sup>1</sup> Subsidy bidding is designed to ensure the provision of socially desirable rail services at least possible costs to taxpayers (Godward 1998, p. 193).

contention seems to be supported by the amount of operating profits reported by Railtrack between 1995 and 1996, before the government successfully sold it into private ownership (see Table 1, below).

**Table 1: Financial performance of Railtrack, 1995 & 1996 (£m).**

	<b>1994/5</b>	<b>1995/6</b>	<b>% Change</b>
Total income	2,275	2,300	1.1
Total costs	1,970	2,004	1.7
<b>Operating profit</b>	<b>305</b>	<b>296</b>	<b>(3.0)</b>

Source: Godward (1998, p. 194).

### 2.1: Accountability for Britain's railways in the post-privatization era

Despite placing ownership and control of Britain's railways into private hands, the government took steps to ensure that the railways continued to operate in the public interest. Consequently, the Office of the Rail Regulator (ORR) was created "to promote economic efficiency and deter train operators who might commit economic offences that detract from this [public interest] goal" (Godward 1998, p. 193, see also [www.rail-reg.gov.uk](http://www.rail-reg.gov.uk)). Accountability to the public interest was thereby made the primary responsibility of the ORR in collaboration with a specially designated safety regulator: Her Majesty's Railway Inspectorate (HMRI), in addition to funders such as the Strategic Rail Authority.

Amongst the specific responsibilities of ORR in relation to Railtrack is the setting of the prices that the company can charge franchise holders for access to the national rail network. Through this power, the Rail Regulator exercises significant influence over

the financial performance of the several franchise holders as well as Railtrack itself (see also Godward 1998).

Whilst an overall assessment of the post-privatization performance of Britain's railways ought to include an evaluation of the performance of rail franchise holders as well as Railtrack, this paper chooses to focus only on the performance of Railtrack plc. In selecting this approach, the paper is better able to directly interrogate the narrative that Railtrack's failure to deliver improved rail services was due to significant underinvestment in its infrastructure in order to show profits (Godward 1998, [www.networkrail.com](http://www.networkrail.com), [www.news.bbc.co.uk](http://www.news.bbc.co.uk)). And, that the payment of dividends to shareholders is largely to blame for this underinvestment and related negative consequences for passenger safety.

### **3.0: Railtrack's performance**

Writing in 2001, Terry observes that

[t]he recent massive disruption to the nation's railway system has provoked some fundamental re-thinking of what privatization and regulation can achieve in terms of better public services. Railtrack is more heavily indebted after four years in the private sector than poor old British Rail, performance standards have plummeted and public confidence in rail – despite the surge in passenger traffic - is at an all-time low (Terry 2001, p. 4).

By all indications, Terry's view is one that is shared by a wide cross-section of commuting Britain. But, commuters have not been the only ones to express dissatisfaction with Railtrack's performance. Beginning in 1996, ORR expressed grave misgivings over what it saw as inadequate amounts of funds being invested to develop the rail network (Godward 1998). Following the publication of Railtrack's 1996/97 financial report, the Rail Regulator restated this concern as follows:

These record profits show that Railtrack has funds available to invest in the network. It is still has a long way to go to deliver on ambitious plans and to make good the £400 backlog on property spending, and the £277 million shortfall on track and structure renewals which still remain. That is why I want to see increased public accountability for stewardship of the network (cited in Godward 1998, p. 196).

Interestingly, a review of the operating profits reported by Railtrack for the three years of its existence (up to 1997) reveals an aggregated profit amount of £905 million. In regarding this sum as evidence that Railtrack could have invested more heavily in network improvements, the Regulator seemed to have been implying that these profits had not been ploughed back into the company, but had, instead, been drained away. This is a curious conclusion coming from the Regulator who has responsibility for the complex calculations that ensure fair and competitive charges between Railtrack and its clients. Certainly, operating as he does in such a financially sensitive position, the Rail Regulator's grasp of basic corporate finance must be better than his statement implied!

In the first place, the view that British railways, under government ownership and control, suffered a long history of underinvestment is virtually uncontested. Hence, continued underinvestment in the network, albeit under a new government-owned company, may be disappointing, but should hardly be surprising. Secondly, considering that Railtrack had been a government-owned and funded company for two of the three years to 1997, the Regulator's inference that profits equal loss of network investable funds, seems hugely ill-informed. Thirdly, were the backlog of network expenditures (£877 million), cited by the Regulator, to have been made out of profits rather than from further public subsidy or commercial loans, it is unlikely that Railtrack would have been able to meet its annual debt service charges. To do so

would, mostly likely, curtail the company's ability to source new investment funds from the private sector, and quite likely force it into even deeper reliance on the public purse: a situation that was inimical to one of the Conservative government's key motivations for privatizing British Rail in the first place.

Since it would, perhaps, be inappropriate to think that the Rail Regulator was naïve in these matters of corporate finance, another explanation must exist for his conclusion concerning the appropriateness of infrastructure investments by Railtrack over these years. And, it is in Terry's 2001 reference to the government's 1993 policy regarding future purchases of railway rolling stock that we find a clue. Terry argues that faced with public and expert scepticism and opposition regarding the announcement that

'future orders would be market-led and determined by what the customer values and what offers best value for money, ministerial statements and speeches switched away from promises that the privatized network would deliver a better quality of service, towards stressing that passengers would notice little practical difference' (Terry 2001, p. 4).

Against this new background, it could be argued then that the underinvestment noted above by the Regulator was merely the fulfilment of one of the government's pre-privatization promise.

But, at the same time, a more cynical perspective might be that signs that Railtrack would most likely fail to meet public expectations for improvements in rail services had become visible in political circles within the company's first year under private ownership. And, in view of the political risks that are associated with this view being held by the public in the run up to an Election (1997),<sup>2</sup> it could not be too early to lay the groundwork for deflecting blame from the political centre to the expendable

periphery. This concern with managing party political risks has long been a pivotal preoccupation of governments; one which, in the case of Railtrack, would have been served by the subsequent official narrative that dividends paid to its shareholders drained the company of crucial investment funds.

This argument is speculative, however. Nonetheless, as will be shown later, despite the many narratives that have surfaced over the years to describe the performance of Railtrack, the one that has shown greatest resilience, and which has been used to justify the creation of Network Rail, relates directly to profit generation and the payment of dividends by Railtrack to its shareholders. But, how well-supported, in financial terms, is this anti-capitalist discourse?<sup>3</sup>

### 3.1: The news media

On the basis of recent news reports from the BBC and other media houses, the case is beyond equivocation. Concurrent with its announcement that Network Rail had completed the acquisition of Railtrack's, BBC Radio 2, on October 3<sup>rd</sup>, 2002, explained that Railtrack's failure to provide a rail network that delivered acceptable levels of reliability and safety was due to the company's focus on achieving profits to satisfy shareholders. This sentiment has been popular with the public, rail commuter interest groups and railway workers' unions especially since the Ladbroke Grove and Hatfield rail tragedies. It can be found also in the academic literature (see, for instance, Godward 1998) as well as appearing at the Network Rail website where it is used as the *raison d'être* of the new corporate entity that replaces Railtrack plc. In fact,

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<sup>2</sup> Minutes of Evidence, Select Committee on Public Accounts, February 15<sup>th</sup>, 1999 (questions 200 – 219) reveal that 'there was a political imperative to privatize as quickly as possible.

in introducing itself to the public, Network Rail, through its website, assures commuters that public expectations of Britain's railways will now be met because:

Network Rail is a private company, limited by guarantee, created specifically to acquire Railtrack PLC and to provide safe, efficient and reliable rail infrastructure. A company limited by guarantee is a 'not for dividend' company. It is a company without shareholders run along commercial lines (www.networkrail.com).

This statement, from the new monopoly manager of the nation's rail infrastructure, leaves no doubt that its regulatory, public interests and state backers subscribe to the belief that the fundamental problem with Railtrack PLC was that the company made the generation of profit and the distribution of dividends to its shareholders a greater priority than infrastructure improvements. It follows therefore, that if greedy shareholders could be jettisoned, then important public service interests would get a chance to prosper. Hence the formation of Network Rail - seemingly devoid of Railtrack's pro-capitalist encumbrances.

But, is the image offered by Network Rail (and the Rail Regulator, above) a fair reflection of the financial performance that describes the Railtrack legacy? Considering that in social welfare states, anti-capital sentiments tend to be embraced with great ease, could it be that powerful opinion leaders have used Railtrack shareholders as a convenient scapegoat in order to conceal a deeper, more systemic failure that plagues the delivery of high quality rail services?

What follows is an attempt to answer these questions by carefully examining financial reports from Railtrack plc to see how the financial operations of the company

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<sup>3</sup> Discourse is defined here as a specific ensemble of ideas, concepts, and categorisations that are produced, reproduced, and transformed in a particular set of practices and through which meaning is given to physical and social realities.

benefited different stakeholder groups that had a close and direct financial interest in the company. If dividends to shareholders did, indeed, cause a disproportionate drain on Railtrack's investable funds, this should show up in any reasonable analysis of the company's financial operations. The overall findings will subsequently be discussed within the context of notions of social constructivism, discourse formation (Foucault 1992, 1984), and mythologies (Barthes 1973); particularly in terms of the likelihood of a socially engineered public optimism for improvements in the national rail infrastructure consequent upon the establishment of Network Rail.

### 3.2: Railtrack's accounts: a different story?

According to Railtrack's chairman 'much has happened since Railtrack was vested as a company five years ago....the environment for rail has changed for the better' (Railtrack 1999, p.6). Supporting the chairman's statement, and under the banner: 'A year of achievements', Railtrack's 1998/99 annual report boasts a number of milestones, including:

- Record level of investment - £1.45 billion<sup>4</sup>;
- £27 billion plan to grow the railway;
- Passenger train kilometres up 8%;
- Freight tonne kilometres up 18%;
- Better processes for managing performance and maintenance;
- 6% improvement in Railtrack minutes' delay;
- 5% increase in renewals spend to £1,166 million;

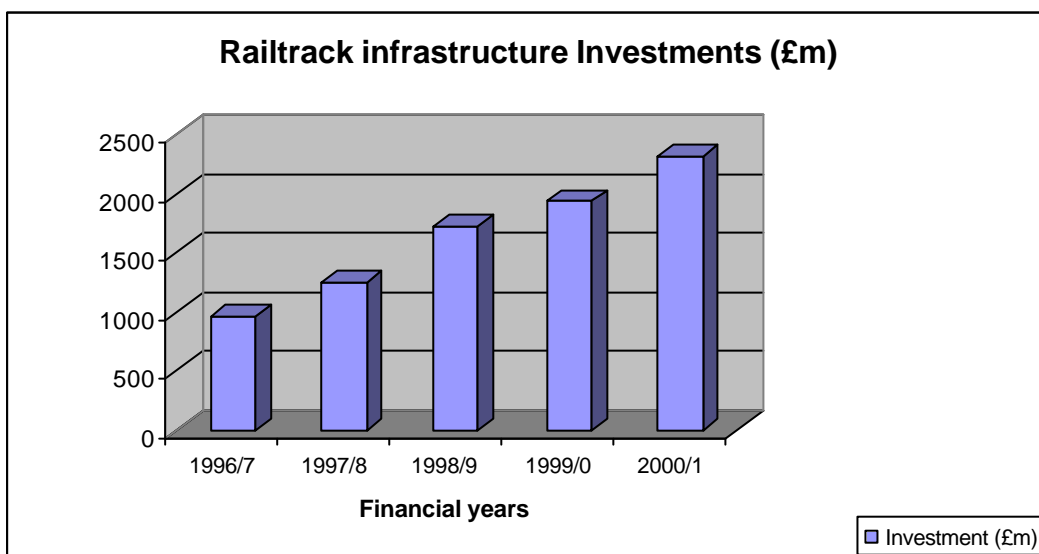
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<sup>4</sup> Excludes investments in the Channel Tunnel Rail Link.

- £294 million of enhancement investment - up 41%.

A multi-year review of Railtrack's infrastructure investments seems to provide justification for the theme: 'the momentum continues' that was used to situate the 1998/99 annual report (see Chart 1, below).

**Chart 1: Railtrack's infrastructure investments (£m) 1997 – 2001.**



Source: Railtrack Group PLC Annual Report & Accounts, [www.railtrack.co.uk/home](http://www.railtrack.co.uk/home).

But, despite the pride of achievement and optimism for the future, conveyed by Railtrack's chairman, the April 1999 network assessment report from rail consultants, Booz Allen, was 'highly critical of the way in which Railtrack discharges its obligations as steward of the national network' (ORR, November 1999, p. 1). In response to the Booz Allen report, the Rail Regulator observed that

[a]lthough Railtrack asserts that it has spent considerable sums on the network, the [Booz Allen] report states that it is likely that there has been a decline in the underlying quality of the network assets as a whole. The implication of this is that, in some respects, the national network may be in poorer condition in 1999 than it was when it was in the hands of nationalised state corporation, the British Railways Board, before 1994 (op. cit.).

Barely two years later, and following the Ladbroke Grove and Hatfield tragedies, Railtrack became the focus of great public derision, and was placed into administration soon thereafter.

Even though the Booz Allen report identified the real problem at Railtrack as the company's inadequate 'knowledge of its assets and its management of them' (ORR November 1999, p. 1), i.e. *management failure*, as was indicated earlier, the dominant discursive expression of subsequent public disaffection was the perception that Railtrack had consistently placed shareholder interests above other, more important stakeholder concerns.

In response to the Booz Allen report and the Rail Regulator, Railtrack argued that

[n]o regulated company can be successful if the regulatory regime under which it operates is wrong..... Railtrack needs to know how its performance will be judged, what happens if it falls short in any year and how we will be remunerated. At the same time, our investors want to be assured that the risks of regulatory enforcement action are no greater than in other sectors..... If Railtrack is to be accountable for delivering the outputs its customers want, then we have to be able to spend what is necessary to deliver a more reliable and better railway and be properly rewarded for the risks we take in developing the railway (Corbett 2000).

Clearly, the issue of chronic underinvestment in the national rail network was one shared by both Railtrack itself and the Rail Regulator. And to better understand what impact profit-making and dividend payments had on Railtrack's infrastructure investments requires examination of how the company's revenues were distributed between different key stakeholders.

#### 4.0: Key stakeholders with a direct financial interest in Railtrack plc.

Stakeholders with a close and direct financial interest in Railtrack plc included shareholders, debt providers, the Treasury, insurance providers, executive and non-executive staff. To determine the degree to which shareholder interests accounted for the Railtrack debacle, it is important to compare the levels of financial benefit that each of the above stakeholders received from the company. This requires careful examination of Railtrack's annual reports and accounts.

Table 2, below, provides a multi-year summary of the company's financial performance.

**Table 2: Group Profit and Loss Accounts (summarised), Railtrack PLC 1996/7 – 2000/1 (£m).**

	<b>1996/97</b>	<b>1997/98</b>	<b>1998/99</b>	<b>1999/00</b>	<b>2000/01</b>
Turnover	2,437	2,485	2,573	2,547	1,890 <sup>5</sup>
Operating costs	(2,098)	(2,087)	(2,102)	(2,184)	(2,362)
Operating profit (loss)	<b>339</b>	<b>398</b>	<b>471</b>	<b>363</b>	<b>(472)</b>
Profit on the sale of properties	38	44	28	56	27
Net interest payable	(31)	(36)	(71)	(59)	(89)
Profit (loss) on ordinary activities before taxation	346	406	428	360	(534)
Tax credit (charge) on profit on ordinary activities	(54)	(34)	(3)	13	227
Windfall Tax charge	-	(156)	-	-	-
Profit (loss) on ordinary activities after taxation	292	216	425	373	(307)
Earnings (loss) per share	66.5p	43.0p	84.0p	73.3p	(59.6p)
Dividends payable to shareholders	<b>(111)</b>	<b>(121)</b>	<b>(133)</b>	<b>(137)</b>	<b>(138)</b>
Dividend per share	22.1p	24.0p	26.3p	26.9p	26.9p
Profit retained in the company for the year	<b>181</b>	<b>95</b>	<b>292</b>	<b>236</b>	-

Source: Railtrack Group PLC Annual Report & Accounts 1997 – 2001.

<sup>5</sup> After exceptional charge of £586 million.

Although not conveying the full picture, Table 2 highlights how revenues generated by Railtrack between 1996/97 and 2000/01 were disposed of. As would be expected, 'operating costs' consumed the largest share. The beneficiaries of profits generated over the period were loan providers, the Treasury, shareholders, and Railtrack itself through profit retained (left over after dividends had been paid to shareholders).

#### 4.1: Operating costs

Table 3, below, describes how some 80% of Railtrack's operating revenues were spent each year.

**Table 3: Breakdown of Railtrack's operating costs 1997 – 2001 (£m).**

<b>Costs</b>	<b>1996/97</b>	<b>1997/98</b>	<b>1998/99</b>	<b>1999/00</b>	<b>2000/01</b>
Production and management expenses	507	528	547	575	1,328*
Joint industry costs	220	213	227	227	
Infrastructure maintenance	732	702	694	663	
Depreciation	639	644	634	719	934
<b>Total</b>	<b>2,098</b>	<b>2,087</b>	<b>2,102</b>	<b>2,184</b>	<b>2,362</b>

\*Denotes combination of production and management expenses, joint industry costs and infrastructure maintenance.

Source: Railtrack Group PLC Annual Report & Accounts 1997 – 2001.

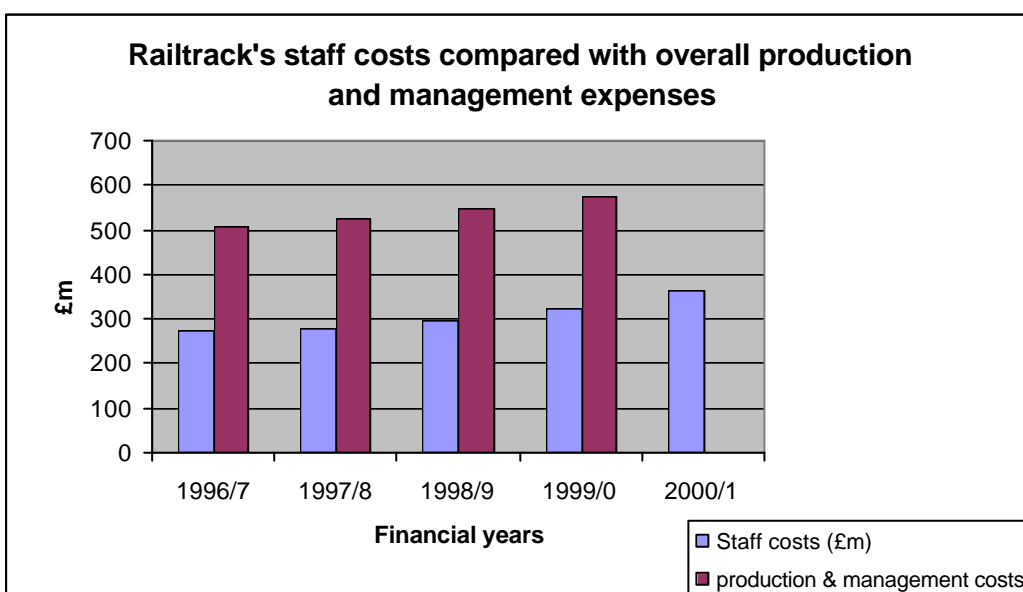
Table 3 reveals two issues of significance:

- Production and management expenses show a consistent upward trend; whilst
- Infrastructure maintenance expenditures reveal a similar, but steady decline in spite of predominantly higher charges for depreciation.

## 4.2: Staff costs

Of the four subcategories of operating costs shown in Table 3 above, ‘production and management expenses’ most closely engages with stakeholders who have a close and direct financial interest in the operation of Railtrack plc. When this subcategory is broken down, it can be seen that staff costs<sup>6</sup> (including directors’ compensation) accounted for over half of the total (see Chart 2, below).

**Chart 2: Staff costs compared with total production and management expenses, Railtrack 1997 – 2001 (£m).**



Source: Railtrack Group PLC Annual Report & Accounts (1997 – 2001).

If 1996/97 is used as the base year, and an aggregate increase in staff costs to 1999/00 is calculated, it can be shown that increases in staff costs outpaced similar increases in overall expenditures on production and management (17.1% compared with 13.4% despite only a 2.4% increase in the number of employees). In fact, when 2000/01 is

<sup>6</sup> Staff costs include wages and salaries, social security, and pension costs.

taken into consideration, staff costs increased by 31.6% since 1996/97; approximately 7.9% each year.

When directors' remuneration is separated from total staff costs, annual increases were even higher. Using 1998/99 over 1997/98 as an example, executive directors received a salary increase of 14.4%, whilst non-executive directors saw their fees increased by 17.1% (Railtrack, 1999). In addition to high annual salary increases,

executive directors and certain other senior executive staff can choose to participate in a long term incentive scheme by deferring up to half of their annual bonus and have that amount of money invested in the company's shares. [And,] depending on the degree of achievement of two key criteria, the company awards the participants an additional number of shares (*between zero and five times the original gross value of the gross deferred bonus*) [emphasis added] (Railtrack 1999, p. 38).

The preceding quotation, and the text from which it was taken, establish a clear link between directors' remuneration and the company's profitability. But, do shareholders, as a group, benefit in the same way as Railtrack directors do when the company makes a profit? Before attempting to answer this crucial question, let us continue to examine how other key financial interest stakeholders have benefited from Railtrack's operations.

#### 4.3: Private sector funders

According to ORR, 'depending on the subject-matter, Railtrack's accountability is to the Regulator, funders, the Health and Safety Executive and train operators' (ORR May 2001, p. 1). And, as was noted by Terry 2001, under private ownership, Railtrack had become more indebted than ever before. In fact, at the end of financial year 2000/01, Railtrack had interest bearing borrowings of some £3.624 billion and non-

interest bearing debt of £833 million. At the time, the interest bearing portion of Railtrack’s overall debt was attracting a weighted average annual interest charge of 6.03% (Railtrack 2001, p. 58).

Obviously, neither the public sector funders of Railtrack nor its commercial and investment bankers were prepared to fund the company under a ‘no strings attached’ approach. In the case of funding from commercial sources, these institutions would have signed loan contracts with Railtrack, requiring the company to make regular interest payments over the life of these agreements. Since failure to honour these loan agreements could have jeopardised Railtrack’s assets, as well as virtually cutting the company off from new sources of commercial loans, debt-servicing was one of Railtrack’s priorities. Hence, over the five years to 2000/01, Railtrack incurred substantial debt-serving charges. In fact, despite the figure that appeared in Railtrack’s annual accounts as ‘net interest payable,’ what the company actually paid out far exceeded these figures (see Table 4, below).

**Table 4: Debt and debt-servicing costs, Railtrack plc. 1997 – 2001 (£m).**

	1996/97	1997/98	1998/99	1999/00	2000/01
Gross interest bearing borrowings	522	864	1,651	2,299	3,624
Weighted average interest charge (%)	N/a	7.5	6.39	6.39	6.03
Interest costs incurred	31	36	87	108	115

Source: Railtrack Group PLC Annual Report & Accounts (1997 – 2001).

Table 4 makes three interesting points:

- To fund its stewardship of the nation's rail infrastructure, the privatized Railtrack had contracted a mountain of commercial debt;
- At no time during the five year period did commercial funders receive less than a weighted average interest rate of 6 %; and
- As a consequence, escalating debt-service costs were a significant expense for the company.

So, with staff costs increasing annually by some 7% and with interest payments to commercial lenders averaging nearly 7%, these two stakeholding groups accounted for a substantial portion of Railtrack's revenues each year.

#### 4.4: Taxation (the stakeholding public)

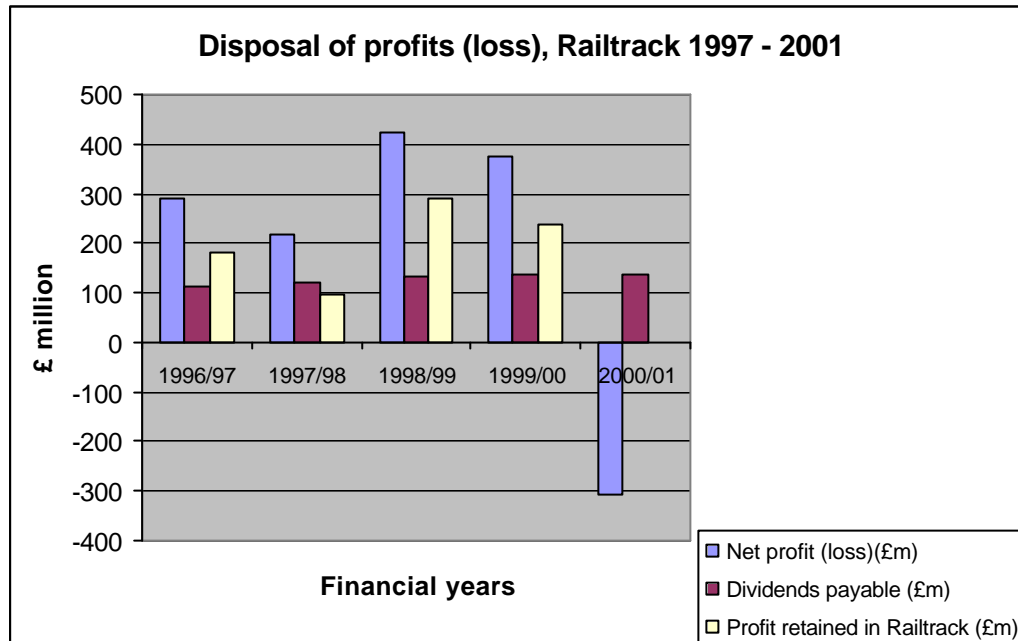
Since only profits from certain parts of Railtrack's operations were exempt from taxation, up to 1999/00, the Treasury was a direct beneficiary of profit-making at Railtrack. For 1997/98, for instance, Railtrack paid over a total of £190 million to the tax authorities (£34 million in corporation tax and £156 million in Windfall Tax). In 1998/99, although the company's profit and loss account showed a taxation charge of only £3 million, this figure masked the real taxation cost of £31 million which had been reduced by the overpayment of corporation tax in previous years.

#### 4.5: Dividends to shareholders

Using data from Railtrack's financial statements (1997 – 2001), Chart 3, below,

shows after tax profits, dividends paid, and profits retained in the company for the five-year period.

**Chart 3: Distribution of Railtrack's profits, 1997 – 2001 (£m).**



Source: Railtrack Group PLC Annual Report & Accounts (1997 – 2001).

If, once again, the middle year, 1998/99 is used as an example, after providing for net corporation tax of £3 million, Railtrack reported net profits of £425 million. Of this sum, £292 million was held back for re-investment in the company, and £133 million or 31.3% was paid-out as dividends. It is this payout to ordinary shareholders that has been used to fuel the perception (knowledge) that Railtrack had placed profit before other important stakeholders' issues such as safety and reliability. But, how significant, for instance, was this £133 million dividend payout to the amount that shareholders had 'invested' in the company, and to Railtrack's infrastructure investment in 1998/99?

If the second part of the question is dealt with first, and considering that Railtrack increased its network investment from approximately £1.3 to 1.5 billion during 1998/99 (see Chart 1, earlier), dividends of £133 million, if used for investment would have increased the company's overall investment by approximately 9%. Whilst this is a significant figure, it should not be overlooked that £292 million of Railtrack's profits for the same year had already been retained for reinvestment in the company. Noting that dividends to shareholders serve the same purpose as the payment of interest to commercial lenders or to staff for their continued labour investment in the company, is it therefore, acceptable for loan providers to receive compensation for investing in Railtrack but not shareholders who do the identical thing, only with greater risk?<sup>7</sup>

To put the £133 million payment to shareholders into perspective requires a basic understanding of how much of shareholders' funds were tied-up in the company in 1999. In other words, if 'US Rail' wanted to buy Railtrack (lock, stock and barrel), how much would they need to pay for each share?

There is a range of different ways of valuing the shares of a public listed company, none of which is impregnable to criticism. Two of the more common methods, however, are:

- setting the value based on the price that the shares traded last on the stock exchange; and

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<sup>7</sup> Whereas commercial loans to Railtrack are usually secured against the company's assets, giving these funders an element of insurance against the likelihood that the company may not be able to repay its debts, shareholders have no such recourse as was demonstrated in 2002.

- calculating a net asset value<sup>8</sup> for the company and dividing this figure by the number of ordinary shares in issue.

Since the price of shares trading on stock exchanges tend to change from minute to minute, in this paper the value of Railtrack will be deemed to be indicated by the sum of the net asset value per share. According to the company's financial statements, this figure was £3.213 billion in 1999, or £6.34 per share (Railtrack 1999, p. 43). This means that irrespective of how much a new Railtrack shareholder might have paid for each of the company's share on the London Stock Exchange on March 31, 1999, what he owned was one share of Railtrack plc that was backed by £6.34 of net company assets. Despite this net asset value of only £6.34, many shareholders paid much more than £10<sup>9</sup> for each share in Railtrack during 1999. Nevertheless, the net assets per share figure of £6.34 will be used to put the issue of dividends paid to Railtrack shareholders in 1998/99 into clearer perspective.

### **5.0: Shareholder dividends as the comparator**

Table 2, above, shows that in 1998/99 Railtrack shareholders received 26.3 pence per share in dividends (£133 Million / 507 million shares). This represents an increase of 9.3% over the amount paid in 1997/98. Whilst this does not match the year-over-year increase in directors' remuneration, on the face of it, it appears to exceed the average increase in staff costs (7.9%) as well as the interest rate paid to debt-providers (6.58%). The conclusion therefore, might be that next to directors, shareholders have

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<sup>8</sup> Total assets less short and long-term liabilities (borrowings and other financial commitments).

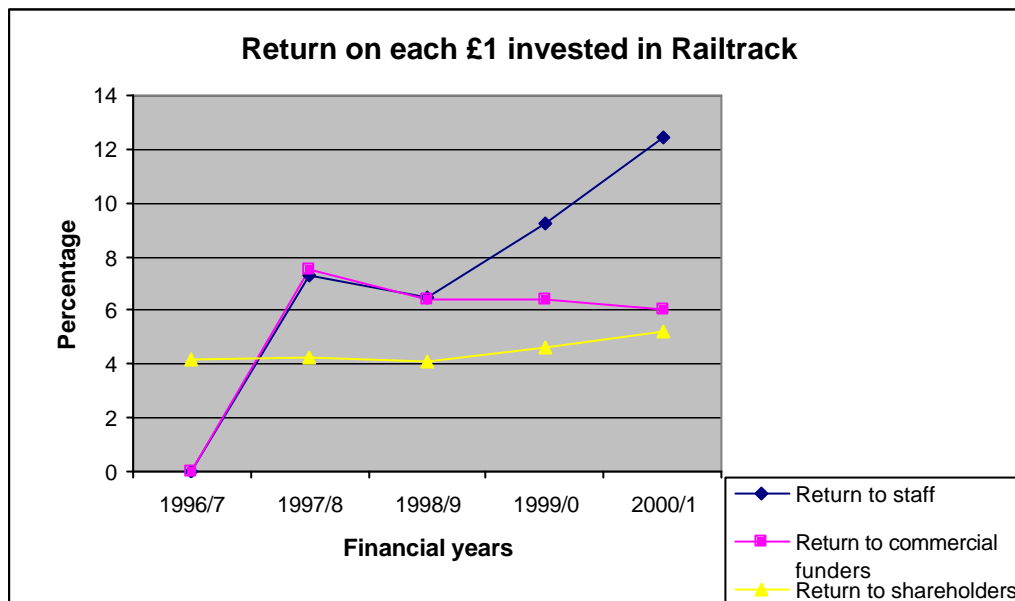
<sup>9</sup> During 1999 Railtrack shares traded as high as £17 on the London Stock Exchange.

been the principal beneficiaries of profit-making/operations at Railtrack. However, this conclusion would be quite erroneous!

If, instead of simply looking at how the nominal amount paid in dividend has changed between 1997/98 and 1998/99, this analysis relates dividend paid to the net asset value of each ordinary share of Railtrack, i.e. 26.3 pence divided by £6.34. The figure so derived (return on net asset per share) shows a return to shareholders of only 4.1%. Compare this return to shareholders with returns in 1998/99 of 17.1% to non-executive directors, 14.4% to executive directors, 6.5% to employees in general, and 6.39% to loan providers. Consider also the return to shareholders who, in 1999, may have bought Railtrack shares at prices in excess of £6.34. Those paying £10 for each share, for instance, would have received a dividend return of just 2.63%.

Chart 4, below, summarises this point and shows that when fluctuations in the price of Railtrack's shares on the London Stock Exchange are ignored, and financial benefit to shareholders is considered in terms of dividend payments only (as the narrative suggests), Railtrack shareholders received considerably less reward on their investment in the company than either Railtrack employees, in general and directors in particular, and commercial funders.

**Chart 4: Comparison of percentage return per £1 ‘invested’ by key stakeholders in Railtrack, 1997 – 2001.**



Source: Derived from Railtrack Group PLC Annual Report & Accounts (1997 – 2001).

Chart 4 and the analysis so far, reveal that:

- Barring the governments Windfall Tax Levy in 1997/98, the proportion of Railtrack’s profit that remained in the company each year for *reinvestment* significantly exceeded the proportion paid out as dividends to shareholders. (In 1998/99 for instance, the proportion not distributed to shareholders was nearly 70%;
- Considering the level of investment made by Railtrack between 1997 and 2001, and the source of those funds, the amounts paid as dividends to shareholders were of marginal significance;
- Other stakeholder beneficiaries of Railtrack plc (directors, staff generally, bankers, the tax department) received financial benefits that, in terms of return on

their 'investment' (labour and loans) surpassed the benefit to shareholders on a return on capital invested basis.

Therefore, if most of Railtrack's annual profits were reinvested in the company, what then is the basis of news media statements like the following from the BBC?

The main difference between Railtrack and its successor is the absence of shareholders. Network Rail will be a company limited by guarantee, meaning that should it make a profit, the cash will be put back into the railways rather than to shareholders. This could enable Network Rail to have a long-term vision (BBC News, Wednesday, 2/10/02, 17.01).

This news report is quite misleading. In the first place, the designation - a company limited by guarantee - has far less to do with what happens to any profit that may or may not be generated,<sup>10</sup> and much more to do with the extent to which the company might be pursued by those (like commercial funders) with a financial claim upon it. Secondly, if profit-making *per se* was the real problem, then it was Railtrack itself that benefited most from it, not shareholders. At the same time, companies that are not subject to the uncomfortable gaze of shareholders might easily choose to use compensation and bonus payments to directors and staff to minimise the amount of profit that is reported each year. Moreover, with the payment of dividend to shareholders being treated as the core problem at Railtrack, there has been no room to discuss whether the company's profits flowed from inefficient or efficient management practices, or, for that matter, whether inefficient practices would have been tolerable as long as no dividends were paid to shareholders.

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<sup>10</sup> E.g. Whereas, claims against the company could wipe-out the assets of the company that gives its shares value, as was virtually the case with Railtrack in 2002, and thereby wipe-out formerly wealthy shareholders, the owners of a company limited by guarantee faces no such risk. The term - limited by guarantee- advises creditors and claimants to be wary.

Furthermore, the BBC news report (above) implied that Railtrack did not have a long-term vision, and associated this with the payment of dividends to shareholders. By implication, all will be well once Network Rail is put in-charge. But, what really underpins this apparent high level of enthusiasm for Network Rail?

## **6.0: Network Rail and the basis for public optimism**

### 6.1: The social construction of knowledge

So far, we have failed to uncover any credible support for the dominant narrative that profit-making and dividends to shareholders caused Railtrack's to fail as stewards of Britain's rail infrastructure. From time to time, arguments concerning chronic underinvestment, management failures and even that privatization of British Rail was a bad idea, have surfaced. Yet, none of these seemed to have survived in the same way that the preceding anti-capitalist narrative. A political view that was restated over several years by the powerful Rail Regulator, railway unions, rail commuter interest groups, academics and the British public in general, despite the lack of credible supporting evidence. How might the resilience of this argument be explained?

The writings on discourse analysis and its impacts on knowledge creation in societies, by scholars such as Foucault (1972 and 1984), Barthes (1973) and others, point us in a useful direction. According to Foucault (1972), for instance, knowledge is created through a process of discourse formation. He argues that:

in every society the production of discourse is at once controlled, selected, organised and redistributed by a certain number of procedures whose role is to ward off its powers and dangers, to gain mastery over its chance events, to

evade ponderous, formidable materiality (Foucault 1972, p. 119).

Thus, in Foucauldian terms, what emerges and prevails as an 'official' discourse is the product of significant and continuous power struggles between competing discourses that create the framework through which certain realities are accepted as 'true' and others are rejected. This premise led Foucault to reject the notion of 'truth' as an absolute, believing instead that both rational and irrational arguments may be appropriated as 'truths' through the exercise of power and influence. In fact, in examining the formation and impacts of official discourses at various levels of the society and over generations, Foucault (1984) formed the view that history is a series of fictions, in which what is significant is not so much what occurred as how people were made to accept a particular perception of what occurred. It follows, therefore that issues of why and by whom, may become of great importance to the researcher/observer.

In *Mythologies*, Roland Barthes (1973) discusses 'the concept of the myth' in a similar way to Foucault's (1972) expose' of discourses. Like Foucault (1984), Barthes separates myths from truths. In his view, 'nothing prevents the myth from being a perpetual alibi' (Barthes 1973, p. 123). It is this notion of myths/discourses providing a political alibi that is of importance to the following discussion of pro-Network Rail and anti-shareholder storylines. Hajer (1995) agrees with Foucault and Barthes. He sees discourse formation as a process of social engineering aimed filtering diverse perceptions of what constitutes the problem into a politically acceptable definition from which acceptable solution options can flow (see also Sharp and Richardson 2001). In such a context, 'the political conflict is hidden in the question of what definition is given to the problem, which aspects of social reality are included and

which are left out' (Hajer 1995, p. 43). The winners in this conflict gain tremendous influence over which particular perceptions of the *problem* are accepted as authoritative and which are discredited. In the case of the Railtrack debacle, the perception that shareholders were to blame has been the narrative to prevail.

## 6.2: Network Rail, the new monopoly rail network manager

Widespread optimism has greeted the establishment of Network Rail as the new body to take charge of the national railway infrastructure. In describing itself, Network Rail states that "[o]ur vision is one of Engineering Excellence for Britain's Railways. We have set challenging, but achievable targets for improving safety and reliability, whilst seeking to reduce costs" (About Us, [www.networkrail.com/](http://www.networkrail.com/)). The approach to be used by the company has been stated on its website as follows:

We have put together our business principles as clearly and concisely as possible - building on the residual strengths of the Railtrack business and in partnership with the industry regulatory bodies.

Underscoring all our activities are a vision and values that together produce a company mission and a set of clear business objectives (Our Approach, [www.networkrail.com](http://www.networkrail.com/)).

What precisely, or even vaguely, is Network Rail telling the public with the preceding collection of words? What message(s), from this description of itself or its approach to managing the national rail infrastructure, justify public optimism? So far, the only answer appears to be the seemingly anti-capitalist ownership structure and control of the new company. But, is this single change likely to be enough?

## 6.21: Ownership and accountability of Network Rail

The following excerpt from Network Rail's website is particularly instructive:

Q. Who owns Network Rail?

Network Rail is owned by its members but will be run by a PLC-style Board. The Membership group will be drawn from a wide range of industry partners and interested parties. The members will have clearly defined and limited powers; they will not run the company....The members have similar rights to those of shareholders in a public company, except that they have no financial or economic interest in Network Rail (and as such no rights to a dividend, for example, or any form of payments).

Q. To whom is Network Rail accountable?

As a company limited by guarantee, Network Rail does not have shareholders (or share capital), but has members. The role of members will be similar to that of shareholders in a public limited company. In particular, members of Network Rail will have an important role in ensuring that Network Rail is managed in line with high standards of corporate governance. Network Rail will therefore be accountable to its members who oversee the conduct of the business. It will operate within the established regulatory framework and funding agreement it intends to conclude with the Strategic Rail Authority.

Q. What power do the members have?

The role of the members will be to hold the board accountable for its management of the business and to ensure Network Rail is managed with the highest standards of corporate governance ([www.networkrail.com](http://www.networkrail.com)).

So, ownership and accountability of Network Rail will be achieved through some 100 members who 'will have clearly defined and *limited* [emphasis added] powers.' Yet, with limited powers, these members will be able 'to hold the board accountable for its management of the business and to ensure Network Rail is managed with the highest standards of corporate governance.' Exactly what will facilitate the achievement of this most admirable objective? Vague and limited powers?

## 6.22: Differences between Network Rail and Railtrack plc

The following is what Network Rail has to say:

It [Network Rail] will concentrate on its core priorities of operating, maintaining and renewing Britain's rail network. We will build on the pride and passion in Railtrack's people, elevating engineering excellence to the heart of the rail network. The innovative structure of Network Rail is designed to ensure that investment will be funded at a very low cost of capital, management incentives will be linked to industry-wide performance targets and the suggestion of profit taking precedence over safety is removed ([www.networkrail.com](http://www.networkrail.com)).

Overall, the pivotal structural/organisational differences that will exist between Network Rail and Railtrack plc may be summarised as follows:

- Concentration on core priorities of operating, maintaining and renewing Britain's rail network;
- Securing very low cost borrowings;
- Linking management incentives to industry-wide performance targets; and
- Removal of the suggestion of profits taking precedence over safety.

But interestingly, the achievement of this new culture of 'Engineering Excellence' is to be built 'on the pride and passion in Railtrack's people.' This comment implies that Railtrack plc did not have or that it failed to display sufficient management capacity to extract the best out of 'the pride and passion' of its employees rather than anything to do with dividend payments or the manner in which the Railtrack was incorporated. And, although this implication echoes the principal concern that came out of the Booz Allen review, viz. management failure at Railtrack, that finding seemed to have had much less discursive resilience.

The issue of executive bonuses at Network Rail has been similarly obfuscated. Network Rail has failed to comment on whether its executives are likely to be better off under the new scheme compared to what existed under Railtrack plc. This issue is simply left for the interpretation of uninformed readers.

But, most important, since Network Rail is not owned through shareholding, there is no possibility of the pre-existing Railtrack incentive scheme continuing even if it was found to be in the public interest. Moreover, assurance that executives of Network Rail will receive 'bonus payments that are linked to system-wide performance measures, such as safety, punctuality and capacity' says nothing about any relationship between the new bonus scheme and surpluses<sup>11</sup> that Network will be expected to make. For instance, it is possible that the targets of safety, punctuality and capacity could be achieved at great financial loss to Network Rail. If such a situation should arise, could this loss be further exacerbated by the payment of large bonuses to target-achieving Network Rail executives?

On the issue of cheaper financing, Network Rail speaks of having 'secured a £9 billion bridge financing facility from a syndicate of leading investment and commercial banks. This will be used to finance the acquisition, refinance Railtrack's existing debt and fund its operations' ([www.networkrail.com](http://www.networkrail.com)). Basically, this 'debt re-financing' action is no more complex than when a homeowner switches his mortgage to a less expensive mortgage provider. In fact, Table 4, above, shows a clear downward trend in the annual interest rates that were paid by Railtrack's debt since privatization.

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<sup>11</sup> It is interesting also, that, instead of profits, Network Rail chooses to use the softer term: surpluses. In this case, is there a difference?

Hence, with Bank of England benchmark interest rates currently at a 38-year low (Barclays Stockbrokers, October 2002), it is hardly reason for celebration that in 2002, Network Rail has been able to secure cheaper funding than Railtrack was able to do in 2001, 2000, 1999, 1998 or any year back to the mid-1960s. Interestingly, Network Rail seems to be expecting plaudits for this 'achievement.'

On the question of safety, Network Rail again continues to bash shareholders, and relies on extremely vague language and existing Railtrack strategies to make their case ([www.networkrail.com](http://www.networkrail.com)).

## **7.0: Discussion and conclusion**

There is general agreement in the privatization literature that in terms of delivering higher quality public services at lower costs whilst simultaneously progressing other key social aims, the politico-economic strategy has produced very mixed results (see for instance, Cohen 2001, Prizzia 2001, Genoud and Varone 2002, Savas 1989, Osborne and Gaebler 1992). This realisation leads some authors to warn against any policy of divestment that is based on the 'bias and easy assumptions' (Cohen 2001) that by nature, private sector management is more efficient and capable than management within the public sector. In Cohen's view the important organizational and philosophical differences that often exist between the private and state sectors should be treated merely as individual elements of a larger decision matrix that must balance political, economic, social, technical and ethical issues.

In the UK, public reaction to the government's policy of privatising key state-owned enterprises, such as British Gas, British Telecom (BT), British Airways (BA), British Rail, water and electricity, have been mixed. Whilst, on the basis of muted criticisms, the British public appear to be satisfied with the new regime that provides air travel and telecommunication services for instance, the privatized railways have been given a distinctly failing grade. And, despite the part played by the many rail franchise operators, it has been towards Railtrack plc, the company that manages the national rail infrastructure, that the full force of public dissatisfaction has been directed.

Whilst it is not clear whether the reason for public disappointment with Railtrack is due to

- the company's failure to fulfil public expectations;
- a classic case of 'I told you so', based on public scepticism of the government's policy to divest British Rail in the first place;
- recent rail tragedies and loss of lives; or
- frustration associated with the central role that rail transportation plays in ensuring the economic and social well-being of the nation as a whole and the failure to get it right; or
- a combination of the above,

the popular view has been that rail services have worsened under private ownership. This state of widespread public dissatisfaction has the ability to do serious harm to the longer-term political ambitions of the governing political party (even if, as in the case of New Labour, it was not in favour of privatization in the first place). The

management of party political risks required, therefore, the establishment of systems that, if necessary, can act to disperse responsibility for any significant failures of the liberalised railway system. And, it is to this important, but rather poorly articulated political incentive for the privatization of public services in general (the opportunity to redirect blame and political costs from the state to private actors within the wider society when things go wrong), that this paper has sought to draw attention.

It can be argued then, that this strategy, which allows governments to successfully ‘pass the buck’ when public services fail and threaten serious political consequences, is aided by a complex process of discourse building. The process of knowledge creation that helps the preceding to take place, according to Foucault does not emerge by chance, but ‘is at once controlled, selected, organised and [carefully] redistributed’ (1972, p. 119). In the case of the dominant narrative to have emerged concerning Railtrack plc, and which has been used to justify the creation of Network Rail; a number of powerful political actors have contributed to the discourse building process – some actively and others passively. And, despite the periodic emergence of other (competing) narratives to explain Railtrack’s failure to be good stewards of the national railway infrastructure, as well as public access to a large volume of financial, organisational and regulatory data that might have challenged the ‘official’ storyline, a single, politically convenient discourse has prevailed. However, careful examination of the company’s annual reports and accounts has failed to find any significant evidence to support this powerful narrative. In fact, the evidence shows that payments to other stakeholders with a close and direct financial interest in the company have consumed proportionately more of Railtrack's resources than the payment of dividends to shareholders.

If the above finding is reasonably accurate, why then has the payment of dividends by Railtrack elicited such derisory comments from the news media, Network Rail, rail commuter interest groups, the public at large, and such silence from the government, the Strategic Rail Authority, the accountable ORR and even former executives of Railtrack plc?

Whilst offering a conclusive response to this question is beyond the scope of the research carried out for this paper, the following provides us with some useful clues. To begin with, it was the Rail Regulator's 1997 statement that appears to have initiated the negative link between Railtrack's profits and its investments in network improvements. This viewpoint was consistent with initial concerns of large segments of the British public concerning divestment of British Rail. And, despite the Booz Allen report identifying management failure as the core problem at Railtrack, the Regulator's periodic repetition of the 'profit versus infrastructure investment' argument, served the social constructivist function of knowledge creation within an already highly sensitised society. The unchallenged coverage of the Regulator's statements by authoritative and powerful media houses, like the BBC, helped to give credence to the storyline.

Since ORR had been constituted as an 'independent' body with responsibility to ensure that the national railway system operates according to certain high standards, statements from this public watchdog body carries enormous weight. However, note should be taken that in discharging its remit, ORR (and institutions like the SRA) are

not completely free from government interference - as the following BBC news report illustrates:

Transport Secretary, Stephen Byers, has again denied threatening the independent rail regulator to prevent him throwing a lifeline to Railtrack. Giving evidence to the influential Commons Transport Select Committee, Mr. Byers insisted that he had done no more than be open and honest with Tom Winsor (BBC NEWS, November 14, 2001).

The above, together with the pressure that was placed on Mr. Byers to resign, as well as on his predecessor, John Prescott, to sort out Railtrack, shows that an independent ORR did not mean independence from government direction. Consequently, in the absence of evidence showing that the government made attempts to dispel or qualify the Rail Regulator's spurious link between Railtrack's profits and its infrastructure investments, it can be argued that, at the very least, the Regulator's statements provided the government with a useful political opportunity; an alibi. In fact, with early signs that the divested railway system was failing to deliver improved services, New Labour (which under the last Conservative government, had promised to re-nationalize the railways if privatisation failed) was badly in need of a political alibi. Like its predecessor, New Labour has become enamoured with private sector involvement in the delivery of public services. In other words, pressure on the government to act on its pre-1997 General Election pledge to re-nationalize the railways would have been significantly reduced if the reason for Railtrack's failure was not privatization itself, but the selfish actions of specific actors within the privatization chain. These actors, according to the dominant narrative, were Railtrack shareholders who required the company to make profits and pay dividends.

Although the main debates that followed the collapse of Railtrack plc raised a range of issues including questioning the wisdom of privatizing the company in the first

place (see for instance, BBC NEWS, October 7, 2001), and despite a backbench inspired, House of Commons motion that the company be re-acquired by government (Haubrich 2001), across Britain, references to New Labour's pledge to re-nationalise the railways were largely muted. Furthermore, despite clear evidence to the contrary (see Railtrack Annual Report and Accounts, 1997 – 2001), neither the government, ORR, SRA, nor Railtrack plc. appear to be unduly disturbed that the public is being grossly misled by Network Rail and others, about what effect profit-making and dividend payments had upon the performance of Railtrack plc. In fact, it appears that as long as the public accepts this storyline, the government is able to escape any significant blame, thereby diverting attention from more long-standing and systemic concerns about improving Britain's railways. Hence, the ensuing public optimism (however unfounded) for Network Rail – a private company without shareholders – provides the government with the breathing room it needs to take another stab at the perennial problem of sorting out this crucial but problematic public service area.

But, in this discourse formation process, the government was not the only significant beneficiary. By allowing 'greedy' shareholders to shoulder the brunt of the blame for Railtrack's failures, former executives would have improved their chances of walking away from the company with their reputations and careers intact. Interestingly, no one seemed to remember or care that, like commercial funders, employees, and executives, shareholders made a financial investment in Railtrack plc, and, like others, were entitled to a reasonable return on that investment. And, even though the rate of return that they received was lower than that paid to other stakeholders with a close and direct financial interest in Railtrack, the buck has conveniently and successfully

been passed down the line and made to stop with shareholders- a supposedly capital hungry group of stakeholders.

In conclusion, by failing to find credible evidence that supports the 'official' narrative concerning Railtrack's failure to deliver improved rail services to commuting Britain, this paper has shown that through careful discourse-building, what in Barthesian (1973) terms might be described as 'myth creation', the UK government has managed to escape any major political repercussions associated with the policy to privatize the national railways. Shareholders and their interests have been identified as 'the villains of the piece.' The hope now must be that Network Rail, 'a company without shareholders', will succeed where Railtrack plc has failed; thereby, removing any future necessity to identify a new villain in this long-running British railways saga.

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