

Opening up the Pandora Box of Deregulation - the deregulation process of the Swedish railway system*

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This paper argues that an important driver of the deregulation of the Swedish railway network was the former state monopolist SJ's ambition to adopt a bottom line approach. The firm by trying to change the regulatory system in a manner favorable to itself, by escaping loss making railway lines and avoiding commitments to invest in the future of railways repeatedly opened up "the Pandora box of deregulation".

The state closed the regulatory reform process with different types of interventions. On the one hand the state made financial concessions to SJ, on the other hand the state tried to restrict the risk that SJ would come back with similar demands in the future. The state wanted to make a credible regulatory change.

In a long term perspective it is probable that SJ has to make more amendments towards becoming a firm operating in a competitive market. The strategy up to now has to a considerable extent consisted of promises of good conduct and profitability in return for a continuation of the monopoly and more subsidies to the railway sector. In many respects have the former monopolist managed to develop the railway operation. New faster trains, higher service levels, improved coordination with local and regional public transport systems, etc. In other respects SJ still has a long way to go and it is here that we find the risks for the management team again opening up the Pandora Box.

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Introduction

It is generally assumed that deregulation, or the regulatory reform, of the public transport starts with a political decision based on rational calculation. The experience of the deregulation of the Swedish railway system presents a rather different story which opens up for other types of interpretations.

The background of the deregulation process in Sweden was similar to that in most European countries, a loss making railway system that had increasing problems to cope with competition from road and air transport. But unlike many other countries the state owned railway operator demanded change and political action.

I argue that an important driver of the deregulation process was the former state monopolist SJ's ambition to adopt a bottom line approach. But the firm by trying to change the regulatory system in a manner favorable to itself by escaping loss making railway lines and avoiding commitments to invest in the future of railways repeatedly opened up "the Pandora box of deregulation". The politicians in response to the demands from SJ have repeatedly sought to end the deregulation process by making additional financial commitments to the railway sector combined with the creation of new regulatory structures enabling Swedish State Railways (SJ) to retain a monopoly position.

In this paper I will discuss how the openings and closures have developed in the Swedish Railway's deregulation process. Before presenting the case of the Swedish deregulation, retold as a selection of critical reform processes, some notions of how a state monopoly railway system functions compared with a competitive system will be suggested. After the case follows a short discussion and conclusion.

Conduct and Performance in a State Monopoly compared with Competition

The deregulation of the railway sector consists in principal of changes in the institutional structure that govern who has the right to own railway track, to operate railway services, to decide on traffic volumes, and to decide on prices and investments. In the old regulatory system governing the Swedish railways there was one operator that owned the railway track, rolling stock etc, decisions on traffic volumes, prices and investments were taken by either the railway operator or by the state. The state or the parliament intervened in the following ways: by purchasing unprofitable railway services, by accepting or refusing price increases suggested by SJ, by accepting or refusing line closures, and by deciding on SJ's major investments. The state also appointed the president of the railway operator and had a substantial influence in other decisions concerning the hiring of top management.

This regulatory system tried to install an equilibrium where factors like social welfare considerations, a widespread network with accessibility to the railway network from almost all cities and villages in the country, and a unified price system were important. At the same time the politicians demanded of SJ that it should if not be profitable at least not loss making.

In consequence we have a system with very peculiar rules for conduct and very non-capitalistic measures of performance. But at the end the system started to malfunction to such a degree that the politicians looked for new rules for conduct and changes in the measurement of performance.

Later on in the text I will present the changes in the regulatory system but two types of changes dominated: a move towards decentralization and an increasing demand on SJ to make profit.

The demand on SJ to make a profit forced the managers at SJ to re-learn the basic cost-benefit calculation, revenue increased in importance, and traffic volume and equity lost in importance. One important aspect of the move from a social welfare oriented state monopoly to competition is about incentives to innovate. A central feature with innovations is that entrepreneurs or organisations that innovate seek to capture a monopoly rent restricted in time. This incentive is of course blurred in a state owned monopoly that seek to maximize consumer surplus under a budgetary constraint. During the old regime management focused on how to minimize costs and the fundamental "innovative" activity consisted in closing unprofitable railway lines or to stop running passenger services on certain lines.

Opening Pandora's box of Deregulation

This chapter consists of a recapitulation of the key regulatory reforms in Sweden from 1979-99.

The Transport Policy Act of 1979

In the late 1970s SJ 's demand to stop operating a couple of unprofitable local and regional railway lines prompted the state to make the first major change in the regulatory system. This first example of regulatory reform came about as a result of SJ's established strategy of cutting losses through abandoning unprofitable railway operations. The regulation, the Transport Policy Act of 1979, gave the local authorities - the county council and the county's local municipality councils - a formal and all-encompassing responsibility for bus transportation.¹ Since also some rail transit operations on SJ's network were included, this represented a first step in shifting the financial burden of non-commercial commuter rail services to the counties and away from central Government. The 1979 Act thereby

¹ J-E. Nilsson, Swedish Railways Case Study, CTS Working Paper 1995:2, p. 175

decentralized the control of local and regional public transport, in each of Sweden's 24 counties was established a County Public Transport Authorities (CPTAs).

An advantage of the new organization was that some of the interest groups that opposed branch line closures got the financial responsibility for these lines. The Act included an agreement that the CPTAs were to receive a state subsidy that gradually diminished during five years in return for taking charge of some of the local and regional railway services. This implied a more complex subsidy system in the railway sector. The state had previously only paid subsidies to cover part of SJ's, capital costs and make the operator postpone line closures. With the new system, the railway sector would also get subsidies channeled through the CPTAs.

SJ continued to push for cuts in the passenger railway services and could now more effectively use the local and regional authorities as a counterpart in discussions over the future of railway lines. An example was the discussions with the local authorities in southern Sweden. In the late 1970's SJ was planning to close all passenger services with local trains in the Malmö-Lund region. The region was therefore facing the choice to either replace these services with bus services or to build up a passenger train system of its own. The municipalities in the western part of Skåne decided to take the full responsibility for providing local passenger train services in the region, leading to the initiative to start the services called Pågatågen in January 1983.²

In the late 1970's and early 1980's SJ differences in train ticket prices increased. The politicians demanded a new ticket system with lower prices for everybody and SJ developed new services targeted for business passengers. The overall results of the increased price discrimination were a significant increase in railway travel, and a slightly negative effect on profitability.

The key results of this first round of regulatory reform were: a stronger focus on profitability for SJ, and a decentralization of decisions and responsibility concerning local and regional railway lines.

The Railway Act of 1985

The 1979 Transport Policy Act did not help advance SJ's financial position. A Railway Act was therefore passed in 1985 aimed at reducing SJ's deficits. With this legislation, the state accepted expanded responsibility for railway infrastructure. With the 1985 Act the state added 80 percent of infrastructure costs to SJ's the capital base while the rest was considered as a grant. Large scale investments in new rail infrastructure were approaching as SJ was about to place an order for the high speed tilting train X2.

² G. Alexandersson and S. Hultén, Sweden in Van de Velde, 1999

SJ was directed to separate accounting for infrastructure from other parts of its business, and the Passenger and Freight Divisions were asked to pay internal fees for infrastructure use. Another novelty in the Act was that SJ had to fund its investments in rolling stock through borrowings on commercial terms, but the government set a ceiling for the maximum amount - 600 million SEK the first year. The Act also instructed SJ to reorganise its subsidiaries and to start to divest activities that did not complement its core rail business. (SJ was however very reluctant to start this process and as late as 1993 SJ still owned a ferry company, SweFerry, the biggest bus operator in Sweden, Swebus, and two forwarding agents, ASG and Svelast, to mention only a few examples.³) Another important decision was that the Act gave SJ the right to organise itself internally and the Parliament committed itself not to intervene in the enterprise's staffing and organising decisions.⁴

To summarise, the 1985 Railway Act was triggered by continuing losses at SJ. The railway operator had accepted the bottom line approach and was looking for new revenue and cutting down on its socially motivated services. The state closed the new round of regulatory reform by allowing SJ to operate more like a normal business firm and to hand out more subsidies. SJ's monopoly position was further questioned by the demands on more transparency in the form of separate account for infrastructure and divestment of non-railway transport activities.

The Transport Policy Act of 1988

The legislators hoped that the 1985 Railway Act would function as a way of getting SJ out of its permanent economic problems. In the near future it was evident that SJ needed to strengthen its financial position. SJ continued to work on the X2 project and an agreement was signed in 1986 with ASEA (today part of Adtranz) concerning the delivery of high speed trains. However, no improvements necessary for high speed train services in signaling, level crossings etc had started. Also in 1986 SJ projected a need for 1 billion SEK in additional state aid. This resulted in a new government plan, the 1988 Transport Policy Act. The Act was motivated by four concerns: 1) the railways were perceived as having environmental and safety advantages that are not appropriately accounted for in an unregulated market, 2) the need to maintain balanced regional economic growth, 3) the road sector was thought to have benefited from the state's responsibility of its infrastructure, and 4) SJ's finances that continued to deteriorate.⁵

The basic goal for Swedish transport policy, as it was set out by the Act of 1988, is to provide the citizens and the industry in the separate parts of the country with satisfactory, safe, and environmentally

³ SJ Annual Report, 1993

⁴ J-E. Nilsson, Swedish Railways Case Study, CTS Working Paper 1995:2, p. 176

⁵ J-E. Nilsson, Swedish Railways Case Study, CTS Working Paper 1995:2, p. 183

sustainable transport services at the lowest possible cost to society as a whole. This socioeconomic viewpoint implies that the transport policy in principal must be designed in such a way that it helps in effective utilization of society's resources as a whole.

Although the main feature of the 1988 Transport Policy Act was the separation of the infrastructure organisation (Banverket) from railway operations (SJ), another important item was that SJ committed itself to cut costs and increase revenue so that net profits would improve by 1 billion SEK within four years. For its part, the Ministry of Transport agreed to continue to subsidize unprofitable services, both on the national network and by subsidies to county lines. In addition, the state made two major financial commitments. Firstly, a 10 billion SEK funding to Banverket for infrastructure renewal. Secondly, the Government took over the economic responsibility for infrastructure maintenance and a system of levying charges was introduced.

Another important regulatory change in the 1988 Transport Policy Act was the transfer of responsibility for the local and regional passenger services to the regional transport authorities, the CPTAs in 1990. This introduced the possibility for competitive tendering for these services. The goal of this policy change was, beside cost savings, to increase the coordination of bus services and railway traffic.

In 1988 as in 1985 the regulatory reform process was opened by SJ and the railway operators demand for new subsidies. The railway operator was unwilling to sell the non-railway activities but needed cash to cover losses and to pay for future investments. The state this time reacted with a more radical reform than before. SJ lost control over infrastructure planning and local and regional railway operations while it continued to have a monopoly over freight and inter-regional passenger railway operations.

The Implementation of the Radical Reform of 1988

The period 1988-96 saw the practical test of the reform of 1988 and to some degree the earlier reforms of 1979 and 1985. During this period SJ was able to fulfill most of its obligations towards the state. A new high speed train entered operation and improved the image of the Swedish railway system, SJ managed to finance the new rolling stock through lease-back arrangements with financial institutions, SJ was profitable for most of the period, and SJ sold many of its non-railway activities.

The former railway monopoly benefited from a massive investments in the Swedish railway network. The National Rail Administration (Banverket) put forward in 1993-94 a large scale investment program in the Swedish railway infrastructure, going beyond the annual 1 billion SEK suggested in the Transport Policy Act of 1988. Instead, 32 billion SEK were to be invested in railway infrastructure over the years 1994-2003. The investments principally aimed at expanding the high speed network, for the first time in many

decades were new railway lines projected on a large scale. On all these lines were SJ able to run high speed regional or inter-regional trains.

SJ was able to fight back a move towards near complete deregulation of the railway business in 1994.⁶ The origin of this planned regulatory reform was that SJ was slow to concentrate on the railway operation and that many politicians thought it necessary to curb SJ's powerful position in the transport market. The end of this process was that the Parliament became divided along political lines. The center and liberal parties favored complete deregulation and the Social democrats together with the former Communist Party favored a continued albeit modified monopoly. When the later constellation won the election in 1994 was a new radical reform abandoned.

The process of introducing more competition on the state's railways reemerged when the Social Democrat Government launched a renewed investigation of the future organisation of the railway sector. This resulted in a new report from the Ministry presented in June 1995, suggesting similar changes as had been suggested during the previous Parliament. For example, the functions of allocation of track capacity and train traffic control should be transferred from SJ to Banverket, while other common facilities were to be available on commercial grounds. Instead of permitting open access for new operators, it was argued that the CPTAs should get the extended rights to run services on the main lines within their respective county and after special Government decisions even services reaching into other counties. The reasoning was that this would promote the development of the local and regional services. For the freight services the report suggested open access on the whole network.⁷ SJ opposed this and pointed at the risks of destroying the gains from economies of scale.⁸ When the Government finally presented its Bill in October 1995, it had partly accepted SJ's arguments, allowing SJ "grandfather's rights" for the freight services it already performed. When the Bill was passed in December 1995 it included a deregulation of the freight services as of July 1 1996, and extended rights for the CPTAs. SJ's exclusive right to perform interregional passenger services was maintained.⁹

⁶ Kommunikationsdepartementet, En öppen järnvägsmarknad i Sverige, Ds 1993:63, Stockholm, 1993

⁷ Kommunikationsdepartementet, Nya möjligheter för järnvägstrafiken, Ds 1995:33

⁸ Svenska Dagbladet, 1995-10-05

⁹ Proposition 1995/96:92

The examples above show that SJ continued to act in such a way as to entice the politicians to discuss further deregulation. The most important failure for SJ was that a competing consortium won the tender to build and operate the Arlanda link. But in this tender SJ behaved as a competitor until it lost the tender. After it lost the former monopolist engaged in lobbying aiming at reversing the decision of the tender. These actions only resulted in a re-negotiation of the agreement between the state and the winning consortium. More important for the deregulation process was the fact that SJ started to use subcontractors to feed railway freight to SJ's long distance freight trains, and a much discussed bid for the regional traffic in Jönköping and Halland. SJ's bid was contested by the firm losing the contract and in 1998 SJ was sentenced to a fine of 8 million SEK for misusing its dominant position by placing a bid too low to cover the firms own costs.

In the period 1988-96 SJ managed to block further moves towards radical regulatory reform. However, the firm continued to be slow to change its conduct towards what it is expected in competitive markets and the firm by subcontracting freight traffic continued to open up new types of railway operation for competition. The fact that SJ made a profit probably helped the firm stop the radical reform in 1994. The reform in 1996 confirmed SJ's most important monopoly positions.

Increased pressure for radical re-regulation in 1997-99

When SJ reported that it was returning to making a loss of nearly 500 million SEK in 1996 the whole regulatory system came under debate. The freight division was once more showed red figures, but also the passenger services performed rather badly. This development formed the background to the final stages of the work of a special committee, KOM-KOM, investigating the future of the transport sector. Its final report was presented in the spring of 1997. Among its most important suggestions were a new division of the railway network into a business network and an inter-regional basic network, and the abolition of track fees for freight transport. The business network, consisting of SJ's profitable lines, should only be accessed by SJ. This is motivated with the claim that railway operation in a country the size of Sweden is a natural monopoly due to economies of scale (but this is not proved in the report). The railway services on the interregional network should however be purchased through competitive tenders, possibly carried out by a new national authority cooperating with the CPTAs.¹⁰

Some other committees wanted to move further towards a competitive market. For example, the committee on "The organisation of coordinated interregional passenger transport" concluded in their final report that all passenger rail services should be open to competition through competitive bids - in case of a

¹⁰ Kommunikationsdepartementet, Ny kurs i trafikpolitiken - Slutbetänkande av Kommunikationskommittén, SOU 1997:35

loss making service the state pays a fee and in case of a profit making line the winner pays a fee to the state. The regulatory reform of 1998 was less far reaching than expected. SJ's monopoly right to the profitable inter-regional railway network was confirmed.

In reality SJ's position continued to be contested. The state's negotiator has become more active and tries to tender all non-profitable railway lines. This means that a line with a potential to become profitable can be tendered and this happened in 1998 when SJ lost the Gothenburg-Malmö line. When it was clear that a competitor had won the contract SJ tried to annul the tender by writing a letter to the government. This situation is described in more detail in G. Alexandersson and S. Hultén, 1999. Another troubling fact for SJ is that some of the small firms that was SJ's competitors in the early 1990's entered alliances to compete more successfully with SJ. In particular the constellation BK Tåg, VIA GTI and Go Ahead Group has been able to win important contracts. Also the delayed sale of SJ's bus operator can eventually strike back towards SJ. In the 1980's SJ would probably have sold the bus operation to a Swedish firm or on the stock exchange in the 1990's SJ got the best offer from Stagecoach a firm that possibly would like to start railway operations in Sweden.

In the last years the politicians have confirmed SJ's monopoly position. But the accumulated effect of earlier regulatory reforms will in the near future result in far reaching changes in the railway market. The Arlanda link will be managed by a competitor, the bidding for tenders will be more competitive as firms and alliances of firms compete for the contracts. SJ is no longer the only big firm competing in the market.

Discussion and Conclusion

SJ through its actions drove the deregulation process in the following manner: 1979, threat of line closures created the first county controlled railway lines. 1985, SJ's wants more liberty and state funding. The state closed the process by providing more subsidies and giving more freedom to management in return the state demanded more transparency. 1988, SJ demands more money to the railway sector. The state gives more subsidies but direct most of them to infrastructure building controlled by the new state agency the National Rail Administration. 1990, the deregulation process moves without SJ's actions with the transfer of the responsibility for the regional passenger services to the local authorities. 1993-94, partly inspired by SJ's lack of willingness to sell non-railway businesses the state investigates further deregulations. This major deregulation is stopped partly because of SJ's intervention and the fact the railway operator is profitable. 1995, a new government opens for competition of freight lines. 1996-97, SJ makes losses on freight lines and show poor profitability for other services, forced to sell its bus operation. 1998, SJ asks for subsidies to provide inter-city services between Gothenburg and Malmö. A competitor wins the tender.

The state closed the regulatory reform process with different types of interventions. On the one hand the state made financial concessions to SJ, on the other hand the state tried to restrict the risk that SJ would come back with similar demands in the future. The state wanted to make a credible regulatory change. Because of the cumulative character of the regulatory reforms the competitive pressure on SJ escalated. Another effect of the deregulation was that other actors with strong political backing entered the railway sector - most importantly the local and regional political authorities and the National Rail Administration. In a long term perspective it is probable that SJ has to make more amendments towards becoming a firm operating in a competitive market. The strategy up to now has to a considerable extent consisted of promises of good conduct and profitability in return for a continuation of the monopoly and more subsidies to the railway sector. In many respects have the former monopolist managed to develop the railway operation. New faster trains, higher service levels, improved coordination with local and regional public transport systems, and to some degree cooperation with other railway operators in Sweden. In other respects SJ still has a long way to go and its here that we find the risks for the management team again opening up Pandora's Box.

When SJ was tried for misusing its dominant position when it under-priced a bid to outcompete a small competitor the former monopolist's preferred line of defense was that the competitor with a turnover less than 1 per cent of SJ was actually the incumbent and SJ was the entrant into this railway market. Another line of defense suggested to the court in case it was found that SJ was a dominant firm was that SJ couldn't calculate its own costs. When SJ was sentenced to a fine the firm decided to make an appeal to a higher court. Another type of conduct that also demonstrates the lack of commitment to the new regulatory structure from SJ's management is that when SJ loses a tender the top management has a too strong inclination to ask the government for a reversal of the decision. These inherent monopolistic conceptions of competition are possibly the biggest threat to SJ, its competitors are investing all their resources in winning market shares and developing new service concepts to attract more customers while too many at SJ still believe in and want to reinstall the monopoly.

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