"The rail network isn’t financially viable"

Deutsche Bahn’s IPO, the privatization of air traffic control and the refusal of the German Federal President to sign the Privatization Act submitted to him: these are the topics that have been making headlines in recent months – and occupying Martin Hellwig, Director at the Bonn-based Max Planck Institute for Research on Collective Goods.

He was a member of the Monopolies Commission from 1998 to 2006 and has been on the Scientific Advisory Council at the Federal Ministry of Economics and Technology since 1995. Hellwig conducts basic research, but he is also familiar with the political perspective.

Is the rail system on the wrong track? If the government pays for the rail network out of its own pocket, then it should also be the owner, says Hellwig.

**MaxPlanckResearch:** Professor Hellwig, the grand coalition decided on the development direction Deutsche Bahn should take: The Bahn will go public, but the rail network will remain under the ownership of the federal government. You yourself have always warned against privatizing the rail network, too. Why shouldn’t Deutsche Bahn be privatized as a whole?

**Martin Hellwig:** In my statements on this question, I have consistently emphasized that the rail network is not economically viable as a private enterprise. The federal government must spend two and a half to three billion euros on it each year. Therefore, it should also remain its owner. I just can’t understand why one would give up control rights for something for which one is footing the bill. I’m not convinced by the idea of a contractual arrangement. Many issues of concern for the government just cannot be regulated by a contract. An owner, however, has control over the property. If the federal government is paying for the rail network out of its own pocket, then it should also be the owner. At the same time, I consider it problematic to ask stock market investors to pay for claims to future government subsidies – which is essentially what it would come down to.

**MPR:** But that wouldn’t be compatible with Deutsche Bahn CEO Hartmut Mehdorn’s original plan to create an “integrated enterprise.”

**Hellwig:** That is correct. However, the separation of the rail network and the operation of railways is also good for competition. This benefits, for example, the German Länder when they pay firms to provide service on certain local and regional routes. They are interested in competition so they don’t have to pay so much. However, competition requires access to the network. We saw this in the telecommunications and electricity sectors. The experience there has shown that, without regulation, without government controls that obligate network operators to provide access at market conditions, there is no effective competition. However, this regulation is particularly difficult when the network operator itself is involved in the downstream activities.

**MPR:** How difficult is it to overcome government monopolies evident from the privatization of the telecommunications industry. Telekom long resisted too much competition and impeded the opening of the networks.

**Hellwig:** I think the first court cases are still awaiting final judgment. That just shows how complicated this process is.

**MPR:** You made some skeptical statements regarding a Bahn IPO before the German Bundestag’s Transport Committee in May. Why?

**Hellwig:** I argued strongly against an IPO with the rail network because the network is not financially viable. I did not make a statement on the question of a separate IPO for Deutsche Bahn transportation without the rail network because I do not know whether this would be viable as a private company. On this point, the business figures presented by Deutsche Bahn seemed questionable to me.

**MPR:** Why?

**Hellwig:** From the time of the railway reform in 1994 until 2003, the stated rates of return on equity were almost consistently on the order of 1 percent – far less than the stock market would expect. There was a slump in 2001, 2002, when Deutsche Bahn wanted to organize its sales like an airline. A huge flop. Since 2003, the rate of return on equity has risen year after year, from 1 to 3, and from 3 to 5 percent. This year, it is forecast to reach 7 percent. But if we look at the figures in detail, this earnings growth includes many one-time effects, for instance from the acquisition of the logistics company Schenker, which is very profitable. But one-time effects can’t be used as a basis for extrapolating trends. That is why I think the forecast of further growth to as much as 8 percent in 2008 is rather bold.

**MPR:** So do you think Deutsche Bahn CEO Hartmut Mehdorn is being too optimistic?

**Hellwig:** Figures can be very patient in the short term. In the short term, the rate of return can be increased very easily by reducing costs, for example by cutting back on track service and maintenance. The sustainability of such a policy, however, is another issue. This reminds me of the typical announcement: “Due to a signal malfunction in northern Germany, the train will be 20 minutes late.” When a newly established private company wants to go public, the first thing investment bankers want to know is: How does the business model work? How sustainable has the business model proven to be? I don’t see any evidence here of sustainable earnings development, and that is why I expressed concern in my report for the Bundestag committee.

**MPR:** In your view, should Deutsche Bahn instead remain in majority ownership of the federal government and be defined as a sovereign task?

**Hellwig:** No. If railway transportation is viable as a private business, then it should be privatized.
then privatization shouldn’t remain at 50 percent, but rather should encompass everything. German taxpayers shouldn’t be participating when this newly developing logistics firm takes entrepreneurial risks overseas, in Spain or anywhere else. Taking such risks is a matter for a private company. This assessment also applies to the transportation business of Deutsche Bahn on the rails. If it really is viable, then I am in favor of privatization.

MPR: And you’re not concerned that privatization could come at the expense of rail passengers?
HELLWIG: That should not really be a problem. After all, customers in other industries are offered reasonable services, too. We don’t say, for instance, “Cars are important to us, so the state must provide them.” I think that, in the case of Deutsche Bahn, the discussion is often a bit too emotional. Whether or not railway transportation can be privatized is not a question of principle, but rather one of feasibility. Some cutbacks in railway operations may be unavoidable anyway, because there are also many things the government can no longer afford.

MPR: What does Deutsche Bahn cost the state?
HELLWIG: The federal government currently pays about 20 billion euros for the railway system, about half of which are inherited debts from the years before the 1994 reform. The other half concern current business. For example, the government spends nearly 7 billion euros on funds given to the Länder so they can pay for the provision of certain local and regional trains. The companies that operate such trains receive not only the prices that customers pay, but also the government’s share of the so-called wholesale subsidy. As a result, the government spends nearly 7 billion euros on funds given to the Länder. This reduces the overall government spending.

MPR: Did regional rail operations become a matter for a private company – as Deutsche Telekom did with Voicestream, or Deutsche Post with DHL. Why should taxpayers participate in these losses?
HELLWIG: In principle, yes. But the question is: What regime can ensure that more traffic moves by rail? Deutsche Bahn has managed to maintain its traffic volumes in recent decades, and even expand it in some areas, but – in relative terms – it has lost market share. It has not kept up with the overall growth in transportation. The reason is, simply, that the rail network has a limited capacity. The available capacity seems to be relatively well used at present. It is unlikely that this would change for the worse following privatization. On this point, it is useful to take a closer look at the railway reform in the United Kingdom. The privatization there has a bad reputation in this country, but all in all, it was more successful than people here tend to realize.

MPR: That is a surprising appraisal. Wasn’t the radical reform of British Rail a failure?
HELLWIG: I think our perception of this is distorted. First, the volume of freight and passenger traffic in the United Kingdom increased significantly after privatization. Second, and this is truly surprising: the accident rate actually decreased. There were one or two spectacular accidents with some injuries and deaths, which immediately drew critics onto the scene. Overall, however, the number of accidents declined following privatization. Of course the British railway had significant problems with its rail network. This was largely due to the fact that, under Margaret Thatcher, the British government had drastically reduced public investment. That helped facilitate budget consolidation in the 1980s, but it also led to a dramatic deterioration of infrastructures. So the British rail network was already run down when it was privatized. Then the regulatory authority stipulated that the companies operating the trains could be given only relatively short-term contracts. This was supposed to foster competition, but it also reduced the operating companies’ incentives to invest resources of their own to improve the network. In the end, the government had to buy back the already privatized and still ailing rail network – at a substantial cost.

MPR: Your basic research is concerned with the significance of collective goods. What do you consider the railway network to be among them?
HELLWIG: The major networks of the railway, the telecommunications system and the energy sector serve as infrastructures for a variety of services that society as a whole. These networks should be viewed as natural monopolies. They are so expensive that it wouldn’t make sense to establish more than one of each. That doesn’t necessarily mean that they must be owned by a public authority. The telecommunications network, for example, is viable as a private enterprise because it recovers enough money for the network. Likewise, this is not true for the rail network, or at least not in its current scope. That is why the federal government invests two to three billion euros every year in the rail network. Of course we could also say that this is too expensive and we should therefore give it up. That would match developments in the US. In this country, however, since 1994, the Constitution stipulates that the federal government bears responsibility for the rail network and must see to it that the network serves the public well. If the federal government is financing it, then it must also call the shots. Perhaps I am a bit naïve on this point.

MPR: What do you consider to be the boundaries of privatization and which collective goods must remain under government control?
HELLWIG: Anything that has to do with police functions, national defense and the state monopoly on use of force should not be privatized at all. Air traffic control, too, includes a police element. Privatization is likewise problematic where social norms, social coherence and equity are at stake. This concerns the primary and secondary education sector, as well as the courts. Here, it is important that all citizens have equal access. The education people acquire in schools is a key element for their participation in society, in business and in political life, and for their overall social integration. For post-secondary education, this is less important. There, the need for social standardization is significantly less. In fact, I see the reverse problem: too much government regulation and too few resources, too little differentiation between the offers – unlike the US with its diversity of institutions, small colleges, private research universities and public universities of all kinds.

MPR: The future role of the state is also very important in relation to a second topical issue: air traffic

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control. This issue recently even occupied the Federal President, who refused to sign the Privatization Act submitted to him. What do you think of this decision?

HELLWIG: I think the decision was right; it shows courage. I don’t really want to evaluate it, but on the whole, I think the Federal President’s refusal was called for by the Constitution – in a matter, incidentally, in which one of his predecessors, Richard von Weizsäcker, already refused his signature. The Monopolies Commission, of which I was a member until June, took up the issue in spring 2006 and concluded that privatization is a delicate matter. Air traffic control involves police functions, which must be assessed by different criteria than normal business activities. Competition plays no role here anyway, because only one company can provide air traffic control in a given region.

MPR: Then why does the federal government want to privatize it?

HELLWIG: Naturally it hopes to generate proceeds from the privatization transaction. Furthermore, users think that air traffic control in its current form is expensive and inefficient. The airlines believe that the airspace capacity is still far from exhausted. However, one must imagine the following scenario: Air traffic control is privatized and is then subject to the principle of shareholder value. The CEO must demonstrate results to financial analysts. One way to deliver results is through cost reductions. From the outside, it is not immediately evident whether lower costs reflect true efficiency increases or higher risks for the future. Therefore, it can be tempting to cut costs even when doing so will have a negative impact on security. I find that unacceptable. And I don’t see the problem as being solved by the company’s liability for accidents or by the government regulatory oversight over the company’s operations. In my view, the community’s interest in air traffic security must be a matter of immediate concern in the company’s own decisions. The importance of this problem is evident from the example of the crash of a Russian passenger jet near Überlingen in 2002. There, the Swiss air traffic control Skyguide had cut back too much on staff. Now, according to the recent judgment of the Constitution – in a matter, incidentally, in which one of my predecessors, Richard von Weizsäcker, already refused his signature. The Monopolies Commission, of which I was a member until June, took up the issue in spring 2006 and concluded that privatization is a delicate matter. Air traffic control involves police functions, which must be assessed by different criteria than normal business activities. Competition plays no role here anyway, because only one company can provide air traffic control in a given region.

MPR: How do you think air traffic control should be organized in the future?

HELLWIG: The Monopolies Commission recommended some caution in reducing the government’s involvement. For instance, by not immediately selling 75 or 50 percent of Deutsche Flugsicherung AG, but only 25 percent. And by not allowing just any investors to buy the shares, but only investors who are also clients. We called this a "club solution": an association of airports and airlines would then call the shots. It is certainly possible to stipulate this by law. These clients have a vested interest in both the safety and the efficiency of air traffic control. They can assess efficiency and risks better than financial investors who have nothing to do with the system. Of course, there is also a risk that, as shareholders of Deutsche Flugsicherung, they may try to use their influence over air traffic control to impede competitors. Preventing this would be the task of a regulatory authority – just like in other industries.

MPR: So the government shouldn’t pull completely out of air traffic control?

HELLWIG: It is important that the federal government not immediately give up its majority position, even if the airlines become involved. This will mean fewer proceedings for the state, but given the court’s judgment in the Überlingen case, in the long run, it may be cheaper for the government if it remains in control.

MPR: The proponents of privatization say that air traffic control is purely a service, not a government task.

HELLWIG: I disagree. The judge who renders a judgment on air traffic control is involved. He is also a risk that, as shareholders of Deutsche Flugsicherung, they may try to use their influence over air traffic control to impede competitors. Preventing this would be the task of a regulatory authority – just like in other industries.

MPR: As a political advisor, you yourself are often caught in the middle, between the lobbyists and decision makers in Parliament and the ministerial bureaucracy. How do you see your role? Do you feel that you can have a positive impact on political processes?

HELLWIG: First, as a Director at a Max Planck institute, I am responsible for basic research. My involvement in the Monopoly Commission was in addition to the research I do at the institute in Bonn, or that I used to do at the university. In this basic research, I study which governance systems are suitable for achieving a reasonable balance between conflicting public and private interests in dealing with collective goods, such as the rail network and air traffic safety. This is a very interesting research subject, quite independently of any advisory activities, and, unfortunately, we still know far too little about it. As for the political side, political decision makers should not be viewed as a monolith. In the years since 1998, when I was on the Monopolies Commission, I have met many politicians who had a really good intellectual grasp of the issues. In some cases better than mine, because they were closer to the facts, in some cases worse than mine because their own interests biased their view. I enjoyed the fact that I was completely independent of such interests. However, I have no illusion about the influence that a scientist can or should exert as an advisor. I hope that we sometimes contribute to keeping the discussion objective. This is easiest when the problems involved are of a technical nature. When massive interests of money or power are involved, scientific advisors are far less able to have an impact. But we must take that in stride.