3 FREE TRAINS OR FREE RIDERS?

Reichmann's windfall train

Paul Reichmann had a dream. He and his brothers would challenge the oldest banking district in the world by building a financial centre on wasteland in the heart of London. They would compete with the City by offering the great financial houses accommodation in purpose-built skyscrapers. They had money aplenty including the biggest property empire in North America, which had amassed assets of $25 billion. Ingenuity was no problem: they had accomplished feats where other entrepreneurs had feared to tread. Had they not built the World Financial Centre on a sandbar in New York's Hudson River? Daring was a family characteristic: in their youth, as Hitler tried to conquer Europe, from their enclave in Tangier they worked to defy the Nazis, launching covert mercy missions to keep alive the victims of the concentration camps.

But without good transport links, their dream was not viable.

Shrewdly, they acquired an 80-acre site on the Isle of Dogs in what was once the heart of a transport hub that knitted together a seafaring empire. The Reichmanns were offered a good deal by the government. Prime Minister Margaret Thatcher, in her bid to regenerate the area, turned Docklands into an enterprise zone. The brothers would be relieved of taxes on rents earned by their company, Olympia & York (O&Y). Here, out of the derelict docks, they could construct a masterpiece that combined the finest architecture with commercial vitality. They would lure the financiers from their mansions in the stockbroker belt to create a real estate for the 21st century. The government's Development Corporation promised to build new roads and, critically, to extend the as yet unopened Docklands Light Railway. The Reichmanns agreed to contribute half the estimated £130 million cost of the extension.

But they soon discovered two flaws in their plan. The light railway had not been designed to carry the traffic volumes that would be required to serve their estate. Even more critical, however, was the realisation that a link into the City was not enough to lure the major tenants. Staff would have to travel first into the old centre of London, then back out to their Canary Wharf. A new line was needed to cut journey times.

The brothers believed they were dealing with a government that understood market economics. But they were reluctant to place their project at the mercy of the bureaucracy. If they needed a train, they would provide one for themselves. They did their sums. They could construct an underground railway that would link the Waterloo and London Bridge commuter rail terminals with Canary Wharf. The line would run eastwards from the rail hubs south of the river, dip under the Thames and deliver in style the lawyers, journalists and bankers whose firms would relocate in their skyscrapers. Based on costs of new railways in other cities, O&Y and its advisers calculated that they could build the railway for £400–600 million.

The numbers were encouraging. With just the light railway – once it was made to work – O&Y could expect to get £20 per square foot per year, enough to cover their costs and make a modest profit. With an efficient rail system linking Waterloo and London Bridge, O&Y could charge something nearer to the £55–60 a square foot that bankers paid for space in the City.[1] This suggested an increase in annual rents of about £30 a square foot. With plans to build more than 10 million square feet of space, they could expect additional annual rental income of more than £320 million. At a 10 per cent discount rate that represented a capital sum of £3.2 billion.

Paul Reichmann took the lead. He recognised that, if all went well, he could recover the cost of the underground line in just two years. But he was walking into two traps. The first was the cycle in the property market. This was rapidly heading for a peak just as O&Y was laying the foundations for its prestigious glass-and-marble buildings. O&Y was to fall victim on a heroic scale. With debts running into billions of pounds, as Britain went into recession in the early 1990s the Reichmanns were driven back to North America by a debt burden that broke records. The second obstacle was the capacity of Britain's bureaucracy to run a guerrilla campaign in favour of the ethos of state control.

The Reichmanns were misled by the propaganda – that the Thatcher government was dedicated to market-based reforms. The problem was not with Margaret Thatcher herself, whose political instincts matched the Reichmanns' financial philosophy. The prime minister had encouraged her ministers to explore new ways of funding infrastructure without loading the cost on to taxpayers. Who, after all, was going to pocket the net gains from a new underground line to Canary Wharf? Why should taxpayers,

1 'London Docklands: where derelict land is a greenfield site', *The Economist*, 13 February 1988.

most of whom would never ride the new line, pay for it when the railway could be financed by billionaire property moguls?

Paul Channon was Thatcher's cabinet minister in charge of transport. He had no hesitation in declaring that the people who benefited would have to pay: 'The Government believes that, if there is to be new investment in transport in London, the passengers who will benefit, should meet the cost of it through the fares they pay, rather than be subsidised by taxpayers in the rest of the country' (Channon, 1989). But the fares paid by passengers would not be sufficient to cover the capital investment in acquiring land, digging the tunnels and laying the tracks. Who would fund the infrastructure? Channon declared: 'Contributions should also be forthcoming from property owners and developers who stand to gain from the improvements to transport' (ibid.).

This was a radical departure from conventional fiscal philosophy. The new doctrine would accomplish two things. First, there would be symmetry between the payments and those who enjoyed the benefits. This was the application of the principle to which we all conform, in the rest of our lives: *paying for the benefits that we receive*. If landowners were going to make money from a new gravy train, why should they not fund it? Second, the idea that 'public' services could – should – be defrayed out of the value of land was a renewal of conservatism in the literal, historical sense. Traditionally, from the earliest civilisations onwards, the services that people shared were financed out of their economy's surplus. This surplus surfaced as the rents that people were willing to pay for the use of land and the resources of nature. That age-old principle had been sidetracked by the revolutionaries of Europe in the late feudal era – the aristocracy – but Thatcher appeared to be excavating the fiscal doctrine for a post-socialist Britain.

The philosophy was precisely stated in a Department of Transport study that was commissioned to examine competing railway projects. London Underground had long cherished a Tube line – called Crossrail – that linked the overland stations at Paddington with Liverpool Street. Should this have priority over Reichmann's line? The question was complicated by a difference over the route that the second Tube line would take. O&Y defined their preferred route, and called it the Waterloo & Greenwich Railway. The transport planners at London Underground toyed with the variations, and they called the O&Y route the Jubilee Line Extension. Whichever project was chosen, there was no doubt about who should pay:

> The evaluation of options has been conducted within the framework provided by the Government's policy on the financing of rail services. This requires that any new line should be paid for by those who benefit including passengers, property developers and landowners ... In the case of the Extension to the Jubilee Line we understand that the Department of Transport has been advised that the *benefits which the line would bring to property developers and landowners are likely to exceed by a substantial margin the cost of the line*, and that a Government contribution to the funding would not appear to be needed. (Halcrow Fox & Associates, 1989: 31; emphasis added)

O&Y endorsed this financial philosophy. Employees already paid the cost of commuting from their homes beyond the green belt; and, suggested O&Y, they would be willing to pay a premium for an efficient, comfortable Tube line that swiftly carried them to their offices every morning. The fare box would collect enough money to cover the operating costs of the trains. As for the capital costs – O&Y was willing to fund the construction of a Tube line that would enhance the value of their real estate.

Paul Reichmann was willing to foot the bill. London Underground would receive – as a gift – a valuable piece of infrastructure that would serve the residents of the capital for generations. No one in living memory could recall such generosity. Mishandling by the government and the transport bureaucracy allowed that gift to slip from the nation's hands.

Turf wars

The obstacles placed in the way of O&Y began with a dispute over the cost of constructing the Tube line. This was estimated by a transport specialist whom the Reichmanns hired from Toronto, their home city in Canada.

Michael Schabas had learnt his transport economics at Harvard's Kennedy School of Government. He then worked on the Vancouver rapid transit system, and was working in Hawaii when he read *The Economist* article that called Paul Reichmann Mr Big. O&Y were doing their sums, and they indicated that they would need a new transport facility. Schabas was hired by O&Y. The Waterloo & Greenwich Railway could be built at a cost of between £400 million and £600 million, estimated O&Y. London Transport rejected the estimate: their experts said it would cost £800 million.

The rule for private enterprise is that when the money is coming out of your pocket you avoid waste: you opt for the deal that is efficient. O&Y did not expect to receive taxpayers' money, so it developed costings in the knowledge that a penny saved was a penny more in profits. But the planners claimed to know better. Schabas was challenged to prove that private enterprise could deliver the Tube line at a lower cost than the public sector. He drew up the specifications and circulated them to five eminent engineering and construction corporations, including Trafalgar House, Mowlem, Taylor Woodrow and Balfour Beatty. Their estimates ranged between £480 million and £600 million. The most competitive quote was £300 million less than London Transport expected to pay. Schabas (1994: 17) recalls that 'dealing directly with contractors, suggesting that London Transport had no monopoly on railway building skills, was seen as a particular affront and won us few friends at 55 Broadway [HQ of London Transport]'.

The next challenge was the time that it would take to prepare a Bill to submit to Parliament for powers to acquire the land. London Transport said it would take a full year – and that the application would have to go through them. O&Y put together a team which prepared a Bill within three months.

The O&Y empire was not built on a propensity to waste resources. It had expanded, building by building across the United States and Canada, with acute attention to detail – and the willingness to work fast. And Paul Reichmann believed that the Thatcher doctrine of private enterprise equipped the government for the ways of the businessman. He was wrong, as he discovered when the day came to negotiate how much O&Y would pay for the new railway.

The cash offer was hand-delivered by Michael Schabas in the late summer of 1988. The outcome was revealed to O&Y executives at their offices in Great George Street. Michael Schabas recalls:

> Paul Reichmann's opening offer was to pay two-thirds of

> the capital cost of the railway. London Underground said 'No!' Paul told us that he was willing to pay the full sum, and hand them the tube line – but we would want to participate in the management of the construction work. Two-thirds was meant to be the opening offer. London Underground needed to go back to Paul with a counter-offer. He waited for them to do so. He had done his sums. He knew that the tube would make it possible for him to charge an additional £30 for every square foot of rentable space. That meant he could recover the capital cost of the railway in two years. But London Underground did not come back to him. They didn't even try to negotiate – they hoped he would just go away.[2]

The moment was lost. The politicians prevaricated. The planners at London Transport preferred to promote Crossrail. The O&Y team read the sub-text. The capitalist developers – and foreigners at that – were upstarts who had no right to interfere with railways, which were in the public domain.

O&Y's attempt to fund and build a railway was an embarrassment for the planners. Margaret Thatcher was furious and insisted they could not just turn away Reichmann's offer. The traditional political escape route was followed: set up another study. That was the fate that befell the Waterloo & Greenwich Railway. The Department of Transport, having commissioned the *Central London Rail Study* (January 1989), then commissioned *The East London Rail Study* (September 1989). As if that did not provide sufficient information to make an informed judgement on what was required to keep the wheels of fortune turning in the London metropolis, the Treasury joined the transport

2 Michael Schabas, interview, 22 January 2004.

agencies to produce a third report in 1990. What was the value of this study to the decision-makers? It purported to compare the costs and benefits of the railway options, employing the London Transport Study Model. This was a 'multi-modal model' (Department of Transport et al., 1990: 19). But the planners' analytical tools excluded:

- environmental costs and benefits;
- savings from fewer road accidents;
- benefits from urban regeneration;
- the value of more jobs in the financial centre and the heightened attractions of London for tourists;
- reduced delays for passengers on the Underground, including the elimination of the need to close 50 stations that had already become dangerously overcrowded during peak travel times.

Were these omissions bizarre, or were they acceptable for decision-making agencies whose responsibility included the environment, public safety, urban renewal, employment and the efficient operation of the rail network? Did the methodology suggest a desire to evaluate projects comprehensively; or an introverted fixation with purely transport-related considerations?

Missing from the official studies was the vision brought to the task of enriching the London economy by enterprises such as O&Y.

O&Y kept close to the East London Rail Study team, to make sure it did not bury their proposals. The Waterloo & Greenwich Railway metamorphosed into the Jubilee Line Extension, a much bigger scheme serving many areas besides Canary Wharf. The costs would be higher because of the plan to connect into the existing Jubilee Line. For London Underground, the Jubilee Line was unfinished business, although the route would have to be changed to serve Canary Wharf.

Although the East London Rail Study (ELRS) would not be published until late 1989, O&Y would not wait. During the summer, it again funded a joint team with London Underground to prepare the necessary legislation, which was deposited with Parliament for the October 1989 deadline. The path through Parliament was now tortuous, however, at least partly because of changes suggested by the planners.

Simon Hughes, the MP through whose constituency the Tube line would pass, wanted stations to be built in Southwark and Bermondsey. The ELRS had suggested these, but the benefits did not match the costs. Hughes promoted the interests of his constituents. He filibustered the Bill. Were the additional stations necessary, and who would pay? Now anxious not to delay the scheme, the Department of Transport recomputed the costs and benefits and reported their findings to Norman Lamont, Chief Secretary to the Treasury. The Bermondsey station, in an area where the land was largely in public ownership, with a heavy incidence of public housing, would cost an additional £23 million, and the benefits exceeded the costs by a ratio of 1.34:1. The Southwark station, if it included an interchange link to Waterloo, would cost £39 million, with benefits exceeding costs by a ratio of 2.99:1.[3] The Jubilee Line's cost escalated, but it appeared that the investment would be worthwhile. There was, however, one little problem: the capital costs could not be covered by the fares from passengers. And O&Y

3 Roger Freeman, 'Jubilee Line extension: Southwark and Bermondsey', letter, Department of Transport, 27 September 1990.

saw no reason why it should foot the inflated bill out of the rents of Canary Wharf.

Simon Hughes argued that the stations would help to regenerate an area that had been neglected. But as for who would pay, there was little doubt: the costs would fall on the nation's taxpayers rather than those who would directly benefit, the residents and businesses in the constituency where the net gains would cascade once the wheels were rolling.

Taxpayers were to foot a bill of £3.4 billion. *The cost was approximately equal to the total uplift in value which the Reichmanns had anticipated for their land alone!*

O&Y commissioned an assessment of what its portion of the total benefits would be. This concluded that the project sponsored by the public sector had overestimated the costs and underestimated the benefits. Crucially, O&Y was not the only estate that would benefit.

> [T]he benefits to landowners are not concentrated in such as [*sic*] way that they form an easily identifiable tax base. The gains to property owners arising from a rail link adding to an existing large network, as the Jubilee Line extension does, will be very diffuse. It is for this reason that the Government decided it could not attempt to collect contributions from landowners and developers benefiting from the East West Crossrail. (Jones Lang Wootton, 1989: viii)

The O&Y critique explored the consequences of increasing the cost of the line from £277 million (if the line were confined to serving O&Y's interests) to the cost that would satisfy the interests of a wider constituency. The Treasury had failed to catch up with the government's fiscal philosophy. It had not suggested a mechanism to enable landowners in Southwark to defray the cost of a new station. Would the landowners have done so to enjoy an increase in the value of their land? One property restorer in the area, Don Riley, would have been amenable. He has since recorded how the properties he manages appreciated as a result of the arrival of the Jubilee Line (Riley, 2001).

O&Y calculated that, in terms of the total uplift in land values, 'Canary Wharf is likely to experience no more than 19 per cent of the betterment, but were Olympia and York to pay 19 per cent of any contribution to the cost of constructing the line, they would, in effect, be subsidising other landowners and developers' (ibid.: x). Why should O&Y *volunteer* to share the capital costs of a railway with taxpayers, enabling other landowners to enjoy a free ride? In the event, it did contribute £100 million.

A four-year episode that did not reflect glory on the politicians and planners ended. As Schabas was to ruefully reflect:

> In retrospect, it was tragic that O&Y's original offer was turned down. Even had O&Y still gone bust, London would have got a new tube line for a fraction of the final price. Private involvement would certainly have speeded the project along and helped keep costs under control. But without support from London Transport's leadership, and without some sort of competitive price check, Government officials lacked the confidence that it could defend O&Y's offer as a good deal. (Schabas, 1994:18)

Despite the Thatcher government's stress on the need for beneficiaries to pay, the new fiscal philosophy had not percolated down to the civil servants. The Jubilee Line was financed in a way that delivered riches to many free riders, at the expense of taxpayers.[4]

Dividing the spoils

How to share the spoils that flow from an improvement in transport did not feature in political discourse until the arrival of the Reichmann brothers.

In relation to the Jubilee Line, the government was left in no doubt that the 'funding gap'[5] could be bridged by the anticipated increases in the rental income that would flow to the owners of land. These rents reflected the enhanced economic opportunities, which were not overlooked by entrepreneurs like O&Y. Schabas identified some prospects when he walked the route of his proposed Waterloo & Greenwich Railway. He reported to Reichmann that many choice sites were ripe for redevelopment. Reichmann replied: 'That's interesting. How secret can we keep this?' Scouts were sent to evaluate land in the vicinity of the proposed stations. Land values, the Reichmanns knew, would rise. But this was not the outcome of a mysterious process. The economics were well understood by North American transport experts. Schabas explains:

---

4 In March 2004, London's Traffic Commissioner, Bob Kiley, reported that a study commissioned by Transport for London from Jones Lang LaSalle estimated that the uplift in land values as a result of the influence of the Jubilee Line was in the order of £2 billion at Canary Wharf and £800 million around the Southwark station. A parallel study by Atis Real Weatherall reported an uplift in property values of a similar magnitude around these two stations. Both reports are available on the Transport for London website (www.tfl.gov.uk).

5 The difference between the present value of the revenues, and the capital and operating costs.

> If you don't charge commuters for the benefits of the new train service, and if there are other benefits – such as reductions in congestion, or improvements to the environment – these are captured by the owners of the land through which people travel. Congestion relief benefits accrue to those who own homes and offices. In that respect, Canary Wharf and its major tenants capture many of the benefits of the Jubilee Line, because they do not have to pay staff quite as much as they would if access to the Isle of Dogs was more difficult.[6]

O&Y would not be the only property company to appropriate the increase in land values. For the principle that was promoted by the government – that the windfall gains to landowners could be used to finance the infrastructure – was not converted into practical solutions. As Schabas noted: 'Nobody came up with a good idea as to how to capture any of this, with two exceptions.' First, the government did not hesitate 'to hold O&Y to ransom … stat[ing] that unless £600 million was forthcoming the line would not be built'. The Reichmanns were veterans at the game of bluff; the government was the first to flinch. O&Y did agree to pay £400 million, but only £100 million was up front. The remainder would be paid over many years. Discounted at the government's 6 per cent cost of borrowing money, the contribution was worth something closer to £150 million.

The second device, suggested by Schabas, was an auction to determine the course of the Jubilee Line along one section of the route just east of Canary Wharf. The East London Rail Study had considered two alternatives, running either via the Greenwich

6 Interview, 22 January 2004.

Peninsula or Leamouth. The Leamouth site was already being developed, and would be served with another branch of the light railway. It was also in fragmented ownership. British Gas, which owned virtually the entire Greenwich Peninsula, won with an offer reputed to be worth £25 million, but part of which was apparently given as land rather than cash (Schabas, 1994: 18). The Jubilee Line trains were routed beneath the Greenwich Peninsula, on which the infamous Millennium Dome was later to be built.

Crossrail remained a dream: the money could not be found. Brian Wilson, MP, speaking at the second reading of the Crossrail Bill on 8 June 1993, declared: 'In respect of Crossrail, we still do not know where the money will come from ... That is a strange way to plan the transport needs of our country for the next century.'

As the planners dreamed, overcrowding on the trains was matched by congestion on the roads. The inefficient circulation of people imposed constraints on the productivity of the London economy. In the early years of the 21st century, government agencies were still arguing with a private sector consortium over who should pay for Crossrail. Another Bill was submitted to Parliament in 2005 to authorise its construction, but there was no agreement on where the funding would come from.

The free riders

The controversial origins of the Jubilee Line Extension (JLE) help us to identify fundamental problems associated with the way transport services are created and delivered.

On the funding of infrastructure, the conventional wisdom is simplistic. Either the money is available from the taxpayer, or it is not. This reduces the financial challenge to a political conundrum.

Margaret Thatcher proved to be more imaginative. She proposed to apply the principle that beneficiaries ought to defray the capital costs. Her initiative failed.

O&Y, as a landowner, could capture some of the additional value that was created by the infrastructure. This value is 'externalised', in the sense that – in a competitive market – it cannot be captured in freight charges and passenger fares. Eurotunnel, for example, unlike O&Y, does not have the commercial scope for 'internalising' some of the rental value which the Channel Tunnel creates. The rents are diffused throughout Britain. Private enterprises that do not also operate as property companies do not have the power to claw back some of the additional value they help to create. For them to do so, they need the cooperation of an enlightened taxing authority.

Did the problem illustrated by Eurotunnel originate in doctrinal confusion over the ownership of the spatial terrain within which our communities are located? Private property rights are exercised, but the state reserves eminent domain unto itself – and it has secured ultimate control over the *use* of land through the planning laws. Has this splitting of rights led to conflicts that distract people from the most efficient uses to which they could put land? This question cannot be sensibly answered until we perceive space as something more than traversable land.

Land is assigned value which may vary considerably over short distances. If there are competing claims over the ownership and use of that value, might this account for the decisions which, on occasion, appear to undermine people's individual and shared interests? Might these conflicting claims account for the absence of symmetry in the distribution of costs and benefits? Might the costs associated with investments on, and use of, space be imposed on one group of people, while the benefits accrue to others? If such an incongruous dynamic is at work, it would be especially evident in transportation, the lattice-work that binds the spatial framework of communities.

Unfortunately, planners employ economic concepts that disguise the consequences arising from investment. Their cost–benefit analyses are framed within the neo-classical model. This treats the economy as two-dimensional, composed of labour and capital (Bannister, 1994: 52). Land is conflated into 'capital'. So for analytical purposes, transport planners denied themselves a comprehensive appreciation of how roads and railways are located in the larger spatial context. That space is an *economic* space, as well as the framework that could be visualised in engineering, or environmental, terms. This was a fatal deterioration in the planner's methodology. For land's *value* is the bridge between space as a biospherical entity and the social reality of civilisation. Transit systems integrate that space, helping to fructify the relationship between a community and its natural environment. Might the failure to incorporate the value of land into transport models account for grievous errors in policy?

Among the issues raised by the Docklands episode is the value-for-money principle. The Blair government think tank on transport, the Commission for Integrated Transport, noted that 'there is evidence of "gold plating" of some UK transport projects to include elements that go beyond the functional (stations on the JLE extension) or for specification of additional, expensive capabilities at the design stage of a project which may be of limited subsequent value. Good design does not have to carry a high price tag' (Commission for Integrated Transport, 2004). The Commission cited staff costs (project management, planning, design and legal issues) which were estimated as 25 per cent of scheme costs in the UK compared with 3 per cent of costs for Spain's Madrid–Lerida Line.

The Commission also highlighted the cost of land, which appeared to be greater than in other countries. But is the high cost of land a problem or, as O&Y represented it, a solution? Within the current funding paradigm, it does indeed appear to be an obstacle. But might it be possible to recalibrate that model to convert the land market into part of the solution?

The need for a radical reappraisal is suggested by the Commission's finding that, if Britain adopted more efficient procedures to finance railways, cost savings of about 20–30 per cent should be possible. This would make a high-speed rail network of the kind enjoyed on the Continent financially feasible. But this would entail changes to processes that are currently cherished by the transport planners. Not least, there are problems with planning procedures, the delays from which increase costs of projects such as the modernisation of the rail network (ibid.: para. 13).

We need to contest assumptions about the interface between the public and private sectors. The Reichmanns were willing to invest their private resources in 'public' services because they appreciated the economic benefits of infrastructure to landowners. If the investment is viable the benefits are diffused *and landowners receive the net gains as increases in land values*. Can this economic process be adapted to resolve problems with investment in transport?

Planners believe that 'the private sector cannot replace the public sector for capital investment in the *infrastructure*, [so] there must be some form of partnership' (Bannister, 1994: 81). This view depends on the way the economic gains from investments are distributed. We shall see that planners (both private consultants and civil servants), on the strength of the information they gather, are not qualified to offer such a dogmatic verdict. O&Y's railway is a metaphor for what may be offered by the private sector, through market economics: a railway that is free to the public, funded by those who benefit from its construction. The alternative is the Jubilee Line, in which the owners of land enjoy free rides on the backs of taxpayers.

But free riders are only a symptom of the general problem of the way in which we use and abuse rent. Can rents be turned from a problem into the solution? Do institutional solutions exist outside the framework of direct government ownership and control? For some answers, we need to travel to the Far East.