Submission to the Department for Transport Rail Review

Prepared by First Economics

May 2004

FIRST
ECONOMICS

info@first-economics.com

First Economics Limited
Registered office: 48 Westway Gardens, Redhill, Surrey RH1 2JB
Registered in England and Wales, no: 5075274

Executive Summary

Recommendation 1:
The DfT must not through its review impose additional obligations or controls on Network Rail. After three lost years, the company has accepted demanding targets for efficiency and delay and now requires a stable political and regulatory environment so that management can concentrate without distraction on the tasks they have been assigned.

Recommendation 2:
The most valuable contribution that the government can make to the rail industry at the present time is to refocus its approach to re-franchising passenger train services and in doing so eliminate significant waste of public money. Cost-plus contracts and short-term extensions to franchises, in particular, are placing considerable pressure on the DfT's budget and must be phased out quickly so as to better harness the private sector's ability to run efficient, punctual and affordable train services.

Recommendation 3:
The government should not prevent moves towards vertical integration taking place if individual train operating companies and Network Rail wish to pursue such ventures. However, vertical integration should not be imposed on the industry by government in the absence of compelling evidence to show that vertical integration is an inherently more efficient or effective model for the railway than the current industry structure.

Recommendation 4:
The DfT's review should leave the powers, duties and jurisdiction of the Office of Rail Regulation intact. Independent economic regulation has made major contributions during the last 12 months towards lowering industry costs and delivering improvements in performance, and must not be characterised as a cause of the problems that the industry has faced during recent years.

Recommendation 5:
While risk aversion and safety concerns remain a substantial problem for the industry, it is unlikely that a transfer of responsibilities among regulators would lead to significant, immediate improvements. Instead, the government needs to rely on Network Rail's management to rein in obvious safety excesses, while accepting that the fall out from recent accidents and resulting prosecutions has irreversibly altered the behaviour of individuals throughout the industry.

Recommendation 6:
It would be inappropriate for the government to make changes to the rights of private-sector freight train operators through its review. Most companies have long-term contracts with Network Rail and the government should rely on the Office of Rail Regulation to keep the terms on which freight is allowed access to the network under review so as to ensure a fair and cost-reflective industry playing field.

Contents

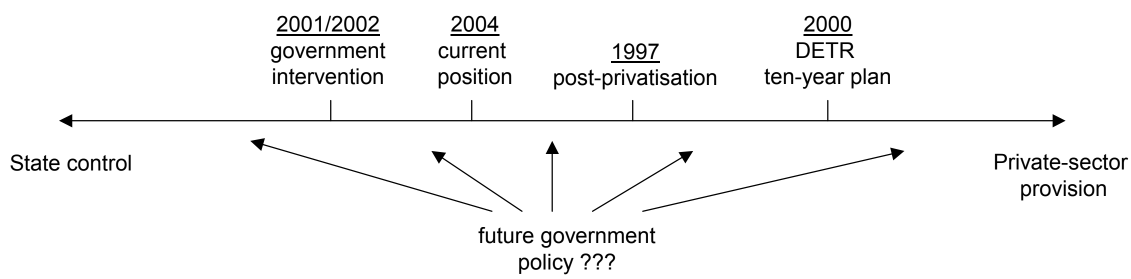
1. Introduction

This paper contains an independent and impartial examination of the issues that the DfT is considering in its current review of the railway industry.

It focuses on how the government can best achieve its twin objectives of (a) improving the punctuality and reliability of Britain's rail services while (b) reducing the cost to the taxpayer of financial support for the industry. To do this, the paper looks carefully at the root causes of the deterioration in performance and increase in costs since October 2000 and aims to differentiate between government responses which deal directly with these problems and those which are likely to have a marginal or even detrimental effect on the achievement of its objectives.

From the outset, it is important to note that the DfT's review looks at a railway that has already seen rapid and disruptive change during recent years. From a privatisation which combined mainly short-term franchises for passenger train operators, open access for new services and independent regulation of the infrastructure, the industry was initially pushed by the shadow SRA along a path towards greater decentralisation, putting the private sector firmly in charge of industry decision-making. In the aftermath of the Hatfield accident the government then pulled sharply back in the opposite direction and started to take a much more visible role in the finances and day-to-day running of the industry. This intervention reached a peak during 2002/03 when the state was implicitly or explicitly underwriting spending in both Railtrack/Network Rail and a majority of the train operating companies, but has been followed by a gradual withdrawal of government involvement.

Figure 1: Government involvement in the rail industry, 1996-2004

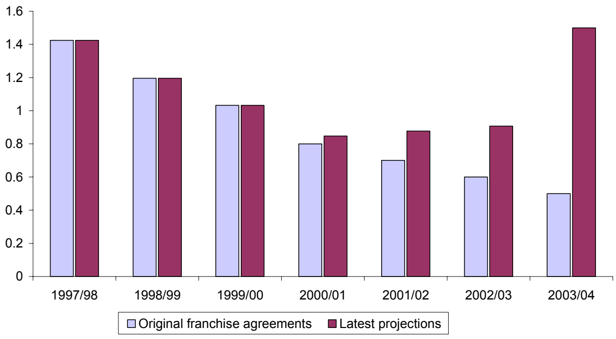


More recently, the DfT and the SRA have been sending mixed signals as to the role the government will play in the industry in future. With costs having risen substantially and performance fallen to unacceptably poor levels, the context for the DfT's review is very different to the one that the government faced in 2000 when it established its ten-year plan for transport. As figures 2 to 5 show, Railtrack/Network Rail and the passenger train operators both bear some responsibility for recent dissatisfaction with the industry:

- on costs, Network Rail is spending almost twice the amount operating, maintaining and renewing the network than Railtrack spent in 1999/00, while the subsidy from the government to franchised passenger train operators has risen to approximately £1.5 billion per annum – more than in the first full year after privatisation; and

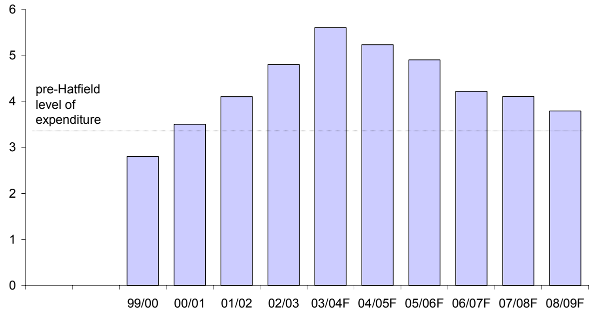
- on delay, the public performance measure for 2003/04 will be just over 80%, down from almost 90% four years previously. Delay minutes attributable to Network Rail have risen by 75% during this time, while delay caused by passenger train operators is down by 20%.

Figure 2: Payments by SRA to train operators (£ billion)



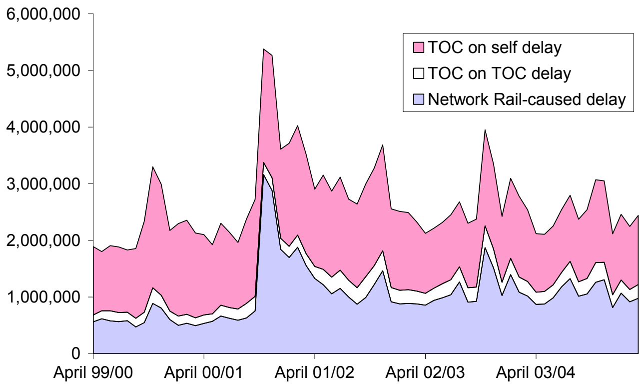
Source: OPRAF/SRA annual reports.

Figure 3: OM&R expenditure by Railtrack/Network Rail (£ billion)



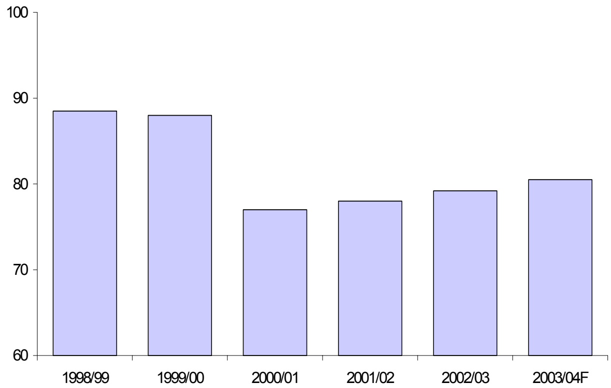
Source: ORR's 2003 access charges review documents.

Figure 4: Minutes delay per 4-week period



Source: ORR.

Figure 5: Public performance measure (%)



Source: SRA 'National Rail Trends' publications.

Against this backdrop, the paper considers the future prospects for the railway in three parts:

- the next section identifies the root causes of these trends by looking separately at Railtrack/Network Rail and passenger train operators' records during the last five years;
- Section 3 then examines the 'solutions' that parties have put forward to the DfT as addressing recent poor performance; and
- Section 4 concludes by identifying which of the measures available to the DfT are likely to have a direct impact on the value that the government obtains from its financial support for the industry.

2. Review of recent developments

2.1 Railtrack/Network Rail

When the Government's ten-year plan was published in 2000, Railtrack was a company spending approximately £3.5 billion and causing only 8 million minutes of delay each year. An accident at Hatfield in October 2000 then revealed serious flaws in management's understanding of the condition of the track and led to an unprecedented meltdown in performance caused by an emergency re-railing programme across the network.

Taken in isolation, the immediate concerns caused by the discovery of gauge corner cracking were dealt with during a period of months and are not today a serious influence on either cost or delay. However, the accident at Hatfield also triggered a separate chain of events which led to a near doubling of the amount that the company spends each year and a doubling of the amount of delay which is attributable to the railway infrastructure. The main stages in this downward spiral have been as follows.

Stage 1: Risk aversion
Railtrack's problems began with the reaction of the public, the media, politicians and subsequent inquiries to the loss of life at Hatfield, and the resulting, very subtle changes in the way in which individuals throughout the industry now approach safety.

It is not possible to document fully all of the changes that have occurred, but evidence assembled during the 2003 access charges review revealed that a basic reluctance among senior management at Railtrack/Network Rail to stick to old asset policies and work volumes has had at least as significant an effect on behaviour as specific modifications or additions to formal safety standards. As a result of this change in attitude, the company concluded early in 2001 that its original business plans presented an unacceptable level of risk and that it was necessary to reassess the whole basis on which it then managed the network.

Stage 2: An increase in replacement work
The most direct consequence of the risk aversion now affecting the industry can be seen in the new found consensus that more work than in the past should be carried out each year to replace worn out infrastructure. While views have varied on the scale of the increase that is required, table 1 shows the ramp up in replacement work for the next five years set out in Network Rail's March 2004 business plan (which, in turn, mirrors the conclusions from the Regulator's 2003 access charges review).

Table 1: Planned Increases in annual renewal volumes by 2008/09 compared to actual work carried out in 2002/03

Category of network infrastructure	% increase
Track	52%
Signalling	52%
Structures	47%
Telecoms	24%
Electrification	380%
Plant and machinery	77%
Stations, depots and other property	76%
Other	- 7%

Source: Network Rail March 2004 business plan.

Although significant in scale, it is difficult to argue that this increase in investment by itself represents a 'problem' for government. Provided that the additional work is carried out in the right places, at the right times and at an appropriate cost, the increase in the amount of investment being poured into the rail infrastructure should feed through into real benefits to the travelling public in the form of shorter journey times, improved reliability and increased punctuality. Since the financial arrangements established in the Regulator's 2003 access charges review also enable this extra work to be financed through borrowing and SRA grants (which count as capital rather than current expenditure in the government's accounts) investment in the railway can now be said to have fallen in line with the government's public commitment to reverse what it has described as 'decades of under-investment' under British Rail and Railtrack.

Stage 3: Administration
What has instead caused problems for government are the decisions that it took when the pressure for higher levels of investment first became apparent. In October 2001, the Secretary of State decided that he was not prepared to allow Railtrack to determine how much extra expenditure should be undertaken and applied to the High Court for the company to be put into administration. However, this decision did not suddenly reduce the volume or the cost of the work that the company was planning to carry out. Similarly, the choice of a company limited by guarantee to replace Railtrack did not, by itself, change the amount of funding that the government would have to put into the company.

What did matter in financial terms was the stance that the government adopted in relation to Railtrack's former lenders and shareholders. Very quickly after administration began, the government made it clear that the company's debts would have to be paid in full by any company wishing to acquire the business. The government also eventually decided that shareholders should receive an amount of around 250p per share, a figure very close to the value at which the company's shares were trading prior to administration. Taken together, this meant that little of the financial consequences associated with the chain of events that began after Hatfield were to be borne by Railtrack's investors. In effect, the government decided to hold shareholders and lenders harmless for future increases in the amount which the company claimed needed to be spent on the railway.

This is important because the government's approach locked in approximately £6 billion of debts (which Railtrack's successor would have to service) and meant that Network Rail would only be financially viable if it was able to obtain a commitment from the Rail Regulator to carry out a review of its income from access charges and SRA grants to reflect the overspending that the company was then engaged in. When companies in other industries enter administration, at least some of the pain of financial restructuring is borne by investors, but in this case the government made an explicit decision to take all of the pain itself in the form of higher future track access charges and/or grants payments to Railtrack's successor.

Stage 4: Removal of incentives
Critically, this pain was then made much worse by the removal of all incentives to control costs. In the 12 months that Railtrack spent in administration, the amount by which the company was overspending increased by almost £1 billion, while the company's projections of future annual expenditures almost doubled. These increases reflected not only the rise in the amount of work that the company wished to carry out, but also very substantial increases in unit costs.

During the course of the Regulator's 2003 access charges review, it became apparent that most of the increase in unit costs, as well as a significant proportion of the increase in additional work, were the result of a lack of basic cost control and straight-forward inefficiencies introduced to the company during and after administration. These inefficiencies are now apparent in all aspects of Network Rail's business, most notably an inability to obtain value for money from contractors, large differences in the cost of carrying out identical work between regions and very substantial HQ overheads.

Although Network Rail is tackling these problems aggressively, it is important to be clear that the inefficiencies arose primarily as a result of decisions taken by the government:

- firstly, the government committed to underwrite all overspending incurred during the year that Railtrack spent in administration, instantly eliminating the internal financial constraints that had previously been imposed on the company's expenditure;

- this guarantee, when added to the government's promise that Railtrack's debts would be honoured and its shareholders compensated, meant that Railtrack's administrators did not have to worry about the amount of money that the company was spending (since overspending would not affect the financial interests of investors, to whom the administrators owed their primary duty of care). This removed any incentive on senior management to manage the business efficiently and led to a break down of central control over expenditure by the regions and their contractors; and

- rather than see these disciplines immediately restored when Network Rail took over, the government chose to extend its underwriting of expenditure for another 18 months (through the Legacy Project Support Agreement) and thereby take on the risk associated with Network Rail's cost control. During this time, the company was held harmless for overspending and knew that its immediate financial position would be unaffected by the progress made in tackling costs.

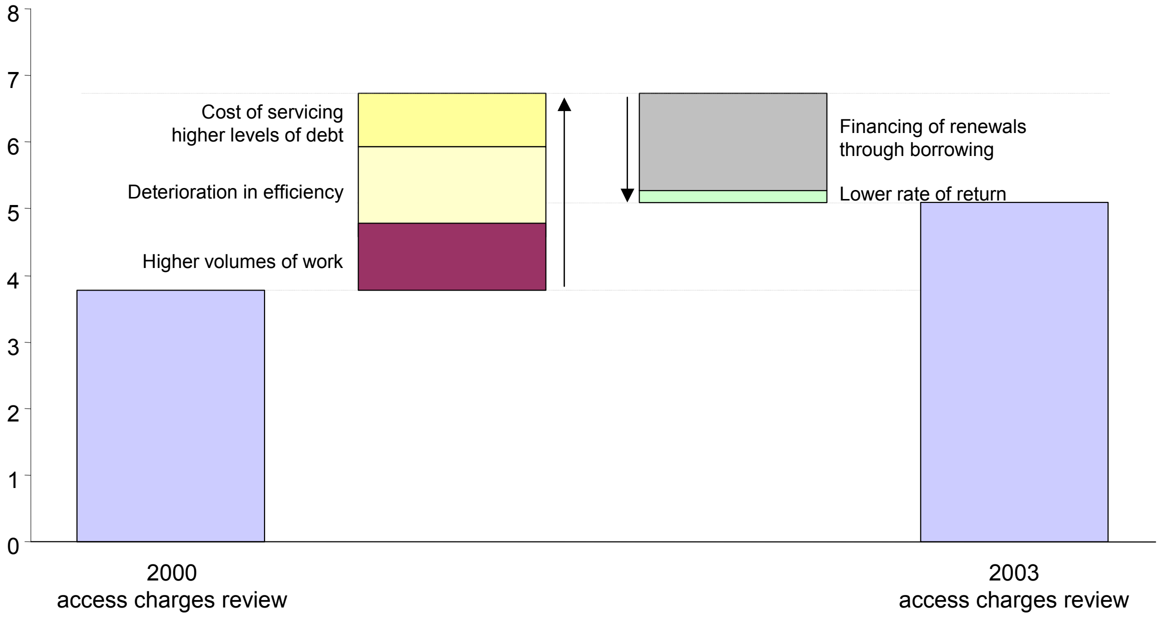
With hindsight, it is now clear that administration had the opposite effect from that which the government had intended: rather than rein in spending, administration actually led to an explosion in costs caused by an absence of any discipline on management (which in turn was caused by the removal of all normal economic and commercial incentives imposed on a network business by its contracts with customers and by its regulator).

Stage 5: Re-establishment of incentives
Incentives to control costs were only reimposed in April 2004 when the Legacy Project Support Agreement expired and the conclusions from the ORR's access charges review were implemented. Revealingly, it is the six-month period running up to this date where the first real evidence of progress in tackling high costs and poor performance begins to show through. In part this is because Network Rail's new management had gained a better understanding of the business they had acquired, but the importance of knowing that the company would jeopardise its ability to meet the new targets then being set by ORR if it were not able to begin to improve efficiency and reduce delay should not be underestimated.

Unfortunately, by the time these incentives began to take effect again, the company had already incurred additional debts of around £7 billion from overspending during the period from October 2001 to April 2004 and had seen its unit costs increase by up to 50% over the same period. The extra debt is a permanent burden for the industry, while the scale of inefficiency within the company will take several years to unwind.

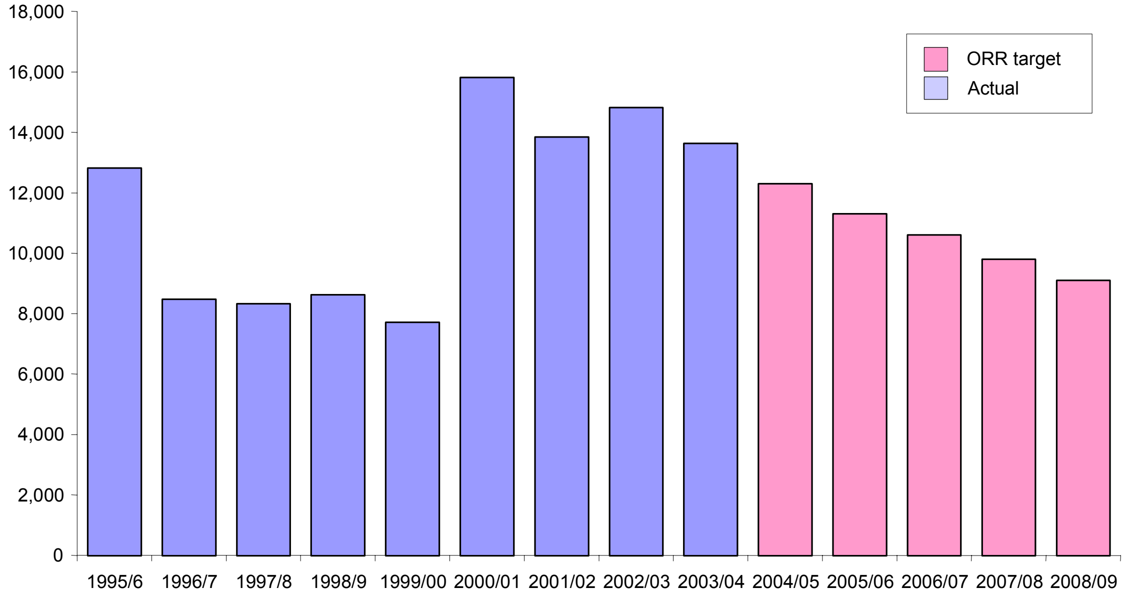
Implications
The chain of events outlined above has left the government in a position where the amount of money that goes in direct or indirect support to Network Rail will more than double by 2006/07 without any consequent improvement in delay minutes beyond pre-Hatfield levels until after 2009, as illustrated by the diagrams below.

Figure 6: Railtrack's 2004/05 revenue requirement as determined in the 2000 access charges review vs Network Rail's revenue requirement for the same year (£ billion)



Source: 2003 access charges review final conclusions/First Economics' calculations.

Figure 7: Actual and projected delay minutes caused by Railtrack/Network Rail



Source: ORR.

There are, however, several important points to note about the position illustrated in these numbers:

- key government policy decisions during the last three years made an increase in government support for Network Rail inevitable. By guaranteeing that Railtrack's debts would be honoured, by agreeing to a substantial payout to shareholders and by explicitly underwriting the business's overspending between October 2001 and March 2004, the government has determined that Network Rail must service around three times as much debt as its predecessor (i.e £12.5 billion versus £4 billion);

- the scale of these debts, the extent of the company's inefficiency and the deterioration in performance would all arguably have been much less had the government not shielded the company from the economic incentives that would otherwise have faced the business; and

- despite all of this, the DfT's budget for 2004/05 and 2005/06 will not be affected by higher costs and debts at Network Rail. Instead, the financing arrangements put in place at the end of the Regulator's access charges review postpone any increase in government support for the company until 2006/07 when, critically, SRA grants rather than track access charges will increase (allowing the DfT to account for its support for Network Rail's expenditure as capital rather than current expenditure).

The position today is nevertheless one in which total government payments to Network Rail will before long become much greater than the support given to Railtrack before October 2001. However, the underlying reasons for this increase have been eliminated and the picture going forward is one in which for the first time Network Rail has clear targets and strong incentives to control costs.

Although it is too early to say how successful management will be as they respond to the targets the 2003 access charges review lays down, our assessment is that the likelihood of real progress is made far greater than at any time during the last three years by the imposition of strong financial incentives.

2.2 Passenger train operators

While receiving less public attention than the problems facing Railtrack/Network Rail, recent experience of franchising has been equally disappointing. When the ten-year plan was compiled in the summer of 2000, Britain's 25 passenger train operators were running almost 90% of services on time in exchange for less than £1 billion per annum of SRA money. This subsidy was expected to decline in future years, thereby freeing up public money to be invested in a variety of new investment projects designed to enhance the capability and performance of the railway.

In reality, subsidies paid to train operators have risen sharply to the point where the SRA has in the last two years overspent the amounts that it was originally allocated by the DfT. As table 2 shows, over two thirds of franchisees have received more subsidies than envisaged at the time of the ten-year plan, either as a result of a renegotiation of their franchises or an extension of the original franchises on more generous terms.

Table 2: Increased subsidy payments from SRA to train operators

Train operator	Date and form of additional support provided by SRA
Anglia Railways	March 2002: franchise moved to cost plus
ARRIVA Trains Merseyside	February 2001: franchise moved to cost plus February 2003: six-month extension
ARRIVA Trains Northern	February 2001: franchise moved to cost plus February 2003: one-year extension
c2c	
Cardiff Railway	February 2001: franchise moved to cost plus October 2001: Wales and Borders franchise begins on cost plus
Central Trains	March 2002: one-off injection of extra subsidy April 2004: two-year extension
Chiltern Railway	

Connex South Eastern	December 2002: franchise moved to cost plus November 2003: franchise handed over to SRA
First Great Eastern	
First Great Western	
First North Western	March 2001: franchise moved to cost plus April 2004: two-year extension
Gatwick Express	
GNER	April 2003: two-year extension
Island Line	December 2003: three-year extension
Midland Mainline	
ScotRail	March 2002: one-off injection of extra subsidy April 2004: two-year extension
Silverlink	
South Central	
South West Trains	February 2003: one-year extension February 2004: three-year extension
Thames Trains	April 2004: two year franchise awarded
Thameslink	April 2004: two year extension
Virgin Cross Country	July 2002: franchise moves to cost plus
Virgin West Coast	July 2002: franchise moves to cost plus
WAGN	Feb 2001: GN moves to cost plus April 2004: GN two-year extension
Wales and West	February 2001: franchise moves to cost plus October 2001: Wessex Trains franchise begins on cost plus April 2004: Wessex Trains two-year extension

Source: SRA press releases and publications/First Economics' calculations.
Note: the table includes all occasions on which the SRA has changed the subsidy/payment profile for a train operator without first fixing the support it provides through competitive tender. 'Cost plus' refers to any arrangement in which the subsidy provided by the SRA is not fixed in advance for a period of at least one year.

Unlike the accident at Hatfield in Railtrack/Network Rail's case, it is impossible to identify a single trigger for this additional call on the SRA budget. Instead, a variety of factors appear to have adversely affected train operators' finances in recent years, including:

- slower than expected growth in passenger numbers and farebox revenue, partly as a result of the problems at Network Rail and partly as a result of a slowdown in economic growth;

- increasing cost pressures from growing staff numbers and other, one-off factors such as higher insurance and pension costs; and

- factors which are within the government's control, primarily the response that the SRA has made to these difficulties and the resulting impact on companies incentives to control costs and improve performance.

The actions of the SRA during the last three years deserve particular scrutiny to understand why it is that an undeniable deterioration in private-sector train operators' financial position has come to have such a significant impact on the public purse. Here, investigations indicate that rather than minimise the call on taxpayers' money, the SRA has in fact significantly worsened the government's budgetary position by failing to recognise the importance of incentivising train operators to control costs. The factors driving this conclusion are as follows.

- *Franchise termination*. All franchise agreements contain provisions which allow the SRA to step in and transfer the franchise to a new operator in the event that the original franchisee becomes financially unviable. However, from January 2001 until the middle of last year,[1] the SRA gave the impression that it had deliberately adopted a policy not to use these provisions, preferring instead to inject additional subsidy to safeguard the continued financial viability of the original franchisee.

- *Poor bargaining power*. This policy not only created poor incentives, it also leaves the SRA at a disadvantage vis-à-vis franchisees during negotiations around the terms on which additional subsidy are to be provided. Without testing the market to determine the terms on which a new owner might be willing to operate the franchise, the SRA has had to rely on the goodwill of incumbents to settle the financial terms on which many franchises will be operated in future.

- *Cost-plus contracts*. Concerns about value for money are further compounded by the fact that the amount of additional subsidy has often been left open-ended as a result of the transfer of franchisees to new, cost-plus management contracts. These contracts provide train operators with very limited financial incentives to control costs, leaving the government bearing cost and revenue risk without any real control over the actions of the train operator.

- *Slow progress on franchise replacement*. With pressure on the SRA's budget coming from non-performing franchises, the SRA has further compounded its financial problems by failing to put in place a process to replace expiring franchises. This has left the SRA with no option but to negotiate short-term extensions with the incumbent franchisee, once again exposing it to all the difficulties associated with obtaining value for money in the absence of a competitive process.

- *Rules for awarding franchises*. Even those new franchises which have been awarded on time may not achieve the best value for taxpayers' money. Critics have frequently complained that the SRA's process for shortlisting bidders and awarding franchises lacks transparency and seem to be based on subjective, rather than objective, criteria. Had the SRA always been clear from the beginning of each franchising process on the specification of the franchise and laid down an objective test for choosing between bidders, it is likely that competition among owner groups would have been far more effective.

The additional cost to the SRA of providing support to train operators beyond that specified in original franchise agreements to train operators is currently around £1 billion per annum (as shown earlier in figure 2). Approximately half of this amount is being injected into just six franchises.

The key points to take from this experience are as follows:

---

[1] This policy contrasts markedly with the stance adopted prior to January 2001, when the shadow SRA was able to transfer a total of six franchises from financially distressed owner groups (MTL and Prism Rail) to new operators without the injection of any additional subsidy.

- unlike in Network Rail's case, additional government support for train operators counts as current expenditure in the DfT accounts and cannot easily be deferred. Arguably, from the government's point of view, this makes cost control among train operators even more important than cost control at Network Rail;

- as of today, the DfT has no budgetary certainty around the amounts that it will pay to train operators over a 12-month, three-year or five-year horizon. Cost-plus management contracts, in particular make forward planning within the current spending review extremely difficult; and

- rather than learn from its experience of the last three years, the SRA appears to be in danger of making the same mistakes all over again by failing to commit to a timetable for franchise replacement, by retaining certain management contract style arrangements in the new template franchise agreement and by failing to include a credible process for dealing with future financial distress in these new agreements.

The position today is therefore one in which many of the issues facing train operators are still to be properly addressed. With around 10-12 existing franchises needing to be replaced during the next two years, the DfT does, however, have a one-off window of opportunity to re-evaluate the government's approach to franchising train operators through its review.

3. Evaluation of ideas offered to the review

Having identified the main causes of poor performance and pressure on the DfT's budget, it is necessary to ask what measures can be taken to address these specific problems. Among the options that the government is examining in its review, there are six main areas in which arguments for change have been made. They are examined in turn below.

3.1 Network Rail

As the focus of more scrutiny during the last three years than any other part of the rail industry, we consider it is vital that the DfT's review steers well clear of further changes to Network Rail or any tinkering with the obligations that it has been asked to deliver. By accepting the conclusions laid down in the 2003 access charges review, the company has already committed itself to contribute significantly to improvements in industry performance and cost. In particular:

- the company is committed to repairing and replacing more of the network in each of the next five years than at any time during the last three decades;
- in carrying out this work, the company has said it will deliver efficiencies of more than 30% in unit costs; and
- as a consequence, delay caused by Network Rail is forecast to fall by 6 to 10% per annum as industry performance moves towards levels achieved before Hatfield within three years.

While improvements were slow to materialise during the first year of Network Rail's existence, the last six months have seen promising signs that the company is starting to deliver. The green shoots of recovery include the very significant improvement in performance during autumn/winter 2003/04 and the publication of a business plan which took seriously the outcome of the access charges review and showed early progress on costs and efficiency.

What the company needs now more than anything else is stability so that it can implement its business plan and focus on meeting and exceeding the targets that it has been set. With strong incentives established by the Regulator in his 2003 access charges review, the best possible framework is already in place to move Network Rail towards achieving the government's policy, and the government therefore needs to rely on the expertise of the company's management and the monitoring regime overseen by ORR to ensure actual delivery. Any moves to changes these arrangements will stall the pace of improvement and risk a softening of the targets that the company has committed to. This in turn will only impose extra cost on the government at the next access charges review.

Recommendation 1: The DfT must not through its review seek to impose additional obligations or controls on Network Rail. After three lost years, the company has accepted demanding targets for efficiency and delay and now requires a stable political and regulatory environment so that management can concentrate without distraction on the tasks they have been assigned.

3.2 Passenger train operators

In contrast to the situation at Network Rail, properly thought out measures to improve performance and (especially) to lower the cost of support to train operators have yet to be put in place. Progress here has been hampered by the absence of a credible strategy to put each and every one of the train operating companies back onto permanent franchise agreements containing strong incentives to lower costs, improve performance and grow revenue.

Recommendation 2: The most valuable contribution that the government can make to the rail industry at the present time is to refocus its approach to franchising passenger train services and in doing so eliminate significant waste of public money. Cost-plus contracts and short-term extensions to franchises, in particular, are placing considerable pressure on the DfT's budget and must be phased out quickly so as to better harness the private sector's ability to run efficient, punctual and affordable train services.

A refocused approach to franchising train services needs to have two main elements:

- first, a properly defined timetable for awarding new franchises, against which the SRA's management could be held formally to account; and
- second, the re-introduction of a template franchise agreement built around an optimal allocation of risk between the SRA and the franchisee.

The former can be accomplished with strong management at the SRA and by ensuring that there is consensus within government at the end of the current spending review as to the amount of money which the country should be spending on passenger train services. The latter component is much less straightforward and needs a far more considered review of the arrangements that the government should put into franchise agreements in order to secure the best possible value for money.

Here, the guiding principle should be one that the Treasury and the National Audit Office apply to all other public-private partnerships:

> *Risk should be allocated to the party that is best able to manage it - either by reducing its size, its likelihood or both – and therefore reduce its cost.*

This well-established rule means that a franchisee should bear the costs and benefits associated with factors that are under the direct control of its management. Conversely, the SRA should not seek to transfer to the private sector the financial consequences arising from factors that the train operator does not exert control over. In a railway context, this means that:

- *cost risk* should generally lie with the franchisee. A train operator's management is in the best position to determine matters such as staffing patterns and wages and to put in place robust cost control measures in order to reduce the cost of passenger train services over time. The franchisee should therefore be allowed to retain the benefits of efficiency savings, while bearing the consequences of most[2] increases in day-to-day expenditure;

- some, but not all *revenue risk* should be borne by train operators through revenue-sharing arrangements that mirror the extent to which farebox income is influenced by factors that are within a franchisee's control. Since the drivers of passenger numbers vary from franchise to franchise, there is no 'one size fits all' rule – it is optimal to have different franchisees exposed to different levels of revenue risk;

- *performance risk* should be split between train operators and Network Rail according to responsibility for the underlying cause of delay. Here, it is difficult to see why the existing 'star' model should be a source of concern to government – by investigating the causes of delay and attributing lost minutes to the party responsible for the delay, train operators not only face fair and strong incentives to improve punctuality and reliability, they also have a wealth of information with which to identify and then tackle the underlying drivers of poor performance;

[2] Where costs are genuinely outside of management's control, e.g. the amount that must be paid to Network Rail in track access charges, it is optimal for the SRA to bear the financial consequences of lower or higher expenditure.

- in order for incentives around costs, revenue and performance to have enough power to influence behaviour, arrangements within franchise agreements need to be fixed for an appropriate *duration* of time. In other privatised industries, a period of at least five years is considered essential for incentives to have real effect. It is difficult to see why similar logic does not apply in the rail industry or why franchises of two or three years in length (or those that allow for changes to be made on an ad hoc basis) will promote sufficient emphasis on cost reduction among train operators.

- where franchises are to be put in place for periods of more than five years, franchise agreements ought to contain provisions for comprehensive *reviews* of subsidy profiles, similar in nature to the review provisions in Transport for London's contracts with the private-sector Tube companies. If designed properly, such reviews would provide flexibility to make franchise changes without altering the risk allocation or damaging the incentives facing the franchisee during the years immediately before reviews; and

- finally, to ensure that the risk allocation within franchises really is fixed, franchise agreements should contain clearly defined procedures for dealing with *financial distress*. These rules would specify the right of each party in the event that the franchise performs worse than expected and, ultimately, a credible process for transferring the franchise to a new operator (including the obligations of the original franchisee once the transfer process begins). Such arrangements are essential to ensuring genuine transfer of risk to the private sector.

A risk allocation developed from the principles outlined above provides strong but targeted incentives for train operators to lower costs, grow revenue and improve performance, and to play their part in achieving the government's overall objectives for the industry. It is quite different from a regime based on 'command and control' in which the government believes it can direct a franchisee's management, but ultimately lacks the ability to oversee day-to-day decision making and so exposes the taxpayer to considerable risk without any ability to control and manage that risk.

While it is apparent that optimal risk allocation is not a feature of existing cost-plus management contracts, it is less clear how the franchises awarded by the SRA during the last 12 months match up to such principles. Having avoided NAO scrutiny of the franchise replacements carried out so far, the DfT would benefit considerably from conducting a detailed analysis of the SRA's current template franchise agreement and obtaining an independent assessment of the value for money that the SRA is likely to obtain from future franchise competitions.

Given the dearth of information in the public domain about the template franchise agreement, it is difficult for us to be more precise about the issues that might be uncovered. However, with large sums of public money to be paid to train operators during the next few years, such analysis is necessary in order to provide the government with the confidence that every pound given to the private sector is well spent.

3.3 Vertical integration

Since it is framed as a review of the industry's structure, the DfT's work will need to consider the merits of vertical integration between Network Rail and train operators. Here, there are two separate questions:

- should the government prevent Network Rail and a train operator from entering into an agreement involving some form of vertical integration if the two parties consider such a move to be in their own best commercial interests; and

- should the government actively require vertical integration in some or all parts of the country?

The answer to the first question must be ‘no’. If two companies believe that there are sufficient benefits associated with cost reductions, increases in the farebox and/or improvements in performance to flow from combining the management of the infrastructure with the provision of train services, there are no grounds for the government to prevent private sector companies pursuing some form of integration. Instead, it is the role of the competition authorities (which may, in this instance, include ORR, the OFT and/or the Competition Commission) to determine whether consolidation is detrimental and, if necessary, to decide if remedies can be put in place to protect the interests of third parties. Such a process is transparent, based on principles that are clearly defined in existing legislation and, most importantly, protects the interests of investors that have put money into the industry.

Actively requiring changes to the structure of the industry to allow vertical integration is something quite different. In order to justify the financial cost and short-term disruption during the transition to a new structure, the government itself would need to have sufficient confidence that a vertically integrated railway will, in the long term, perform better and/or cost less than one which separates the infrastructure from the running of trains. It is, though, extremely difficult to identify economies of scale and scope that might come from combining two very different types of activity. While there may appear to be benefits associated with, say, better coordination in the planning of engineering work or swifter response to incidents, it is not at all clear why the same outcome cannot be achieved through contracts containing strong incentives that align the interests of the two parties.

In other industries, including other network monopolies and railways overseas, companies have been able to operate quite successfully under regimes that provide for separate ownership of the network and the companies that use that network. There does not therefore appear to be any inherent reason why the same basic structure cannot work in the UK railway; rather, many calls for vertical integration seem to stem more from a deep frustration with Railtrack/Network Rail’s performance during recent years and a belief that ‘someone else’ could do a better job. It would be wrong, though, to *impose* vertical integration on one or more unwilling companies based only on experience during a three-year period in which Railtrack/Network Rail’s behaviour has been badly distorted by the removal of all economic incentives.

Recommendation 3: The government should not prevent moves towards vertical integration taking place if individual train operating companies and Network Rail wish to pursue such ventures. However, vertical integration should not be imposed on the industry by government in the absence of compelling evidence to show that vertical integration is an inherently more efficient or effective model for the railway than the current industry structure.

3.4 Independent economic regulation and the role of the SRA

Ever since the shadow SRA first came into being, a number of commentators have expressed concern about the ability for the SRA to use its powers in a manner that brings it into conflict with ORR. While the presence within the industry of two decision makers with similar objectives should not by itself be a problem, potential for overlap in the work of the two organisations arises from the fact that existing legislation hands each organisation distinct and broad powers without then going on to demarcate properly the jurisdiction in which these powers may be exercised.

The extent to which this overlap causes difficulties has varied since the creation of the SRA. Three years ago, the SRA and ORR were clashing on a regular basis, but relations improved significantly with a change of leadership at the SRA and the signing of a concordat between the two organisations at the beginning of 2002. Since this time, the working relationship between representatives of ORR and the SRA (and, indeed, government more generally) have been generally been open and constructive, although a series of disputes among the two organisations' leadership have again been apparent in newspaper headlines during recent months.

Past experience shows that the potential for conflict is greatest in dealings with Network Rail. However, the extent of disagreement on points of genuine substance has been vastly exaggerated to the point where some influential industry figures seem to have the impression that ORR has in the past frustrated government policy objectives and failed to take account of the implications of its decisions for the public purse. A careful analysis of ORR's decisions will demonstrate that these accusations are wholly unfounded. Especially since the creation of Network Rail, ORR has gone to considerable lengths to solicit the views of the SRA, the DfT and HM Treasury and to accommodate government's needs. This is seen most clearly in the 2003 access charges review and the degree of consensus that underpinned ORR's conclusions on the amount of income that Network Rail should be allowed and the manner in which the company should be regulated. In particular, it is apparent that:

- in line with wider government objectives to drive down the cost of the railway, ORR put in considerable effort to identify cost savings and future efficiencies over a period of 12 months and in doing so reduced the amount that Network Rail claimed that it needed to spend on the railway over the next five years by approximately £10 billion;

- similarly, ORR put better performance at the heart of its objectives for the review and has required Network Rail to return delay back to pre-Hatfield levels much earlier than the company had originally claimed to be possible;

- in designing the financial framework for Network Rail, ORR pushed far harder than the SRA initially considered appropriate on the returns that Network Rail would earn each year and on the scope for renewals to capitalised be financed through borrowing, eventually saving around £6-7 billion from Network Rail's five-year revenue requirement;

- in relation to the incentive framework, the way in which ORR has chosen to regulate Network Rail over the next five-year period has received the explicit support of the SRA; and

- perhaps most importantly of all, it is apparent that ORR went out of its way to accommodate the DfT in the final stages of the review when it became apparent that an increase in track access charges could not be accommodated within the DfT's budget, effectively extending the review by two months and eventually agreeing to a financing package which deferred funding increases for two years and allowed the SRA to increase the amount that it pays in capital grants.

This experience is representative of the broader relationship between government policy and ORR's decision making and shows very clearly that independent economic regulation has been instrumental in helping the government towards its objectives for the industry. Without the diligence and cooperation of ORR, the government could not possibly have got to a position where the DfT's current expenditure for the next five-year period is to be *reduced* by the conclusions from the recent access charges review. Indeed, it is quite possible that the outcome of the review would have been less favourable to government had it not been able to leave decisions on key financial issues in the hands of an independent regulator (especially the deferral of revenues).

Recommendation 4: The DfT's review should leave the powers, duties and jurisdiction of the Office of Rail Regulation intact. Independent economic regulation has made major contributions during the last 12 months towards lowering industry costs and delivering improvements in performance and must not be characterised as a cause of the problems that the industry has faced during recent years.

If criticism is appropriate of the relationship between ORR and the SRA it is in the manner in which the SRA has in the past exercised its powers when attempting to gain control over Network Rail. Through its ability to give grants, loans, guarantees and other payments, and in doing so attach conditions to this support, the SRA is able through contracts to amend, duplicate or add to the obligations imposed by ORR on Network Rail. When Network Rail is formally a subsidiary of the SRA and when such large amounts of the SRA's budget are taken up by support to Network Rail, it is perhaps understandable that the SRA should seek to obtain a direct relationship with Network Rail in this way. However, in bypassing and overriding a regulatory regime which has shown itself to be very accommodating to government's needs, such action almost always causes conflict with ORR, frustration at Network Rail and confusion across the industry more generally.

The DfT's review can only eliminate the source of conflict by amending the powers handed to the SRA by the Transport Act 2000. Since it is difficult to see a direct link through to costs or performance, the case for new legislation in this area is quite weak. However, if the government does decide that action is necessary to prevent further disputes breaking out between ORR and the SRA, or to underline that ORR takes sole responsibility for the regulation of Network Rail, relatively simple changes could separate the role of the SRA from the role of ORR:

- first, the SRA's powers to give grants, payments, loans and guarantees, can be limited so that they do not apply to Network Rail;
- secondly, the SRA's strategies, as defined by section 206 of the Transport Act 2000, can be confined solely to the procurement and improvement of train services in Great Britain; and
- thirdly, support currently provided by the SRA to Network Rail can be transferred to the DfT, while the Regulator's duty under section 4 of the Railways Act 1993 to have regard to the financial position of the SRA could become a duty to have regard to the financial position of the DfT.

Changes of this sort would focus the SRA more tightly on the job of getting the best value for money from train operators and leave ORR to concentrate on the regulation of Network Rail. This should not be viewed as fragmentation, but rather as a clear demarcation of jurisdictions in an industry where independent economic regulation is essential and where it is sensible to have only one decision maker take responsibility for the oversight of Network Rail.

Importantly, such changes do not in any way diminish the role that government would continue to play in all decisions taken by ORR. Indeed, as part of any legislative changes, the transparency and importance of the DfT's financial position, government policy objectives and the government's intentions for future franchises could, if the DfT wishes, be strengthened further by formalising the process by which the DfT and SRA provide input to the ORR during each access charges review. Here, a useful comparison may be drawn with the role that government is playing in Ofwat's reviews of water and sewerage charges:

- at the very beginning of the periodic review process, the Secretary of State for Environment issued guidance to Ofwat specifying clear objectives for the review and asking the regulator to investigate certain issues of concern for government. The Secretary of State for Transport, however, chose at the beginning of the 2003 access charges review to issue very general guidance to ORR concerning mainly process;

- so as to understand the government's position on the key issues for the review, Ofwat wrote an open letter addressed to the Secretary of State for Environment one year prior to the conclusions of the review asking the government specific questions and requesting that she amend her guidance accordingly. On the other hand, ORR has previously chosen to communicate with government through its published consultation papers and private meetings; and

- the Secretary of State for Environment has been asked to publish revised guidance to Ofwat at least twice more prior to the conclusion of the review in December 2004. By contrast, the Secretary of State for Transport chose not to update his guidance to ORR,[3] instead electing to make government's views known to the regulator through regular, informal and private meetings of officials.

It is, of course, open to the government at any time to make its views on the regulation of Network Rail formally and publicly known by issuing guidance to ORR. Having chosen not to do so during the last access charges review, and so allowing a false impression to emerge that government views were ignored, there is a case for making small amendments to the Railways Act 1993 (primarily around the scope, content, timing and publication of the guidance which the Secretary of State should provide to ORR during an access charges review) so as to make the government's position an explicit and public part of ORR's decision making and thereby bring the railways in line with practice the water industry. Given the very substantial weight which ORR must place on the government's views, even minor changes of this nature would help the government to demonstrate that it has real ability to guide the decisions which ORR makes on network outputs and charges, whilst at the same time reinforcing its commitment to leave the final decision on such matters to independent economic regulation.

3.5 Safety

The Secretary of State's speech in Parliament in January 2004 promised that the DfT would look carefully at the regulation of safety. As noted earlier, there is widespread evidence that individuals working in the railway have become more risk averse during the last three years and that a growing reluctance to tolerate safety risk is reflected in changes both to industry safety standards and the interpretation of existing standards.

While the government is right to expect the industry to tackle the over-prescriptive application of safety rules, more concerted moves to review written safety standards and/or the process by which standards are established really only deal with the symptoms of risk aversion without addressing the underlying causes. Unfortunately, the causes are much less tangible than anything that can be written down in formal rules and policies and instead go to the personal consequences that can arise from involvement in events leading up to an accident.

It is unlikely, therefore, that institutional change by itself could enable a more sensible position on safety risk to emerge overnight. That said, it is right that the government looks carefully at the duties imposed on the HSE by legislation in order to ensure that the HSE does not act as an impediment to change.

Recommendation 5: While risk aversion and safety concerns remain a significant problem for the industry, it is unlikely that a transfer of responsibilities among regulators would lead to significant, immediate improvements. Instead, the government needs to rely on Network Rail's management to rein in obvious safety excesses, while accepting that the fall out from recent accidents and subsequent prosecutions has irreversibly altered the behaviour of individuals throughout the industry.

[3] The SRA, for its part, made only very brief responses to ORR's consultation papers.

3.6 Freight

The Secretary of State also indicated in January 2004 that the rights of freight train operators would not be a focus of the review. Unlike most passenger train operators, freight train operators do not operate under franchise agreements and do not require direct funding from government to be financially viable. The levers of control which the government can use to gain influence over decision making in the freight industry are therefore much less direct than in other parts of the railway.

That does not mean to say that the position of freight should not be kept under constant review. At a high-level, government policy towards roads and heavy lorries has a significant impact on the market within which the rail freight industry competes – going forward, the government should ensure that its fiscal policy reflects the true costs and benefits associated with the transport of freight by different modes. Separately, ORR will keep under review the terms on which freight are allowed access to the network and has said previously that it will look again during the next two years at whether the charges that operators currently pay to Network Rail should change when existing access agreements expire. As in all of ORR's work, the government will at this time have an opportunity to set out its views on freight operators' access to the network and can expect these views to carry considerable weight in ORR's decision making.

Recommendation 6: It would be inappropriate for the government to make changes to the rights of private-sector freight train operators through its review. Most companies have long-term contracts with Network Rail and the government should rely on the Office of Rail Regulation to keep the terms on which freight is allowed access to the network under review so as to ensure a fair and cost-reflective industry playing field.

4. Conclusion

When the Secretary of State for Transport announced the current review in January 2004, he made it clear that the railway would remain a partnership between public and private sectors. The public sector's role is to put in place the best possible structure and organisation for the industry; the private sector participates by operating the railway more efficiently and with better quality of service to passengers than the public sector would be able to deliver.

It is the presumption that the private sector is more efficient than the public sector on which the whole basis for private-sector participation is based. If the opposite was true, it would be impossible to justify the higher returns which the government must offer to private-sector companies (whose cost of capital is higher than that of the government) and the railways should instead be run by the state. Indeed, this is not a rule that applies only to the railways, but rather a rule which is formalised across government in all aspects of the state's relationship with private-sector firms.

Looking today at the current structure of the railways, the fundamental question the government must therefore ask itself is whether or not it has a structure in place which maximises the efficiencies and performance that it can obtain from private-sector companies and in doing so generate the best possible value for taxpayers' money. This in turn requires the government to look closely at the incentives which companies have to reduce cost and delay and to assess whether the allocation of risk is optimal. The analysis set out in this paper demonstrates that during the last three years, incentives have been removed from large parts of the industry as the government has taken on financial risk which it is not well placed to manage. The result has been an explosion in costs and a deterioration in performance to unacceptable levels.

Going forward, though, it is clear that remedial action has been put in place to address at least parts of this problem. In particular, the 2003 access charges review has enabled Network Rail to commit to challenging new targets and provided a degree of budgetary certainty for the DfT for a period of five-years. Progress has been much slower as far as passenger train operators are concerned, where the government is handicapped by a mixture of slow progress in the replacement of expiring franchises and by the prevalence of cost-plus financial arrangements in those parts of the country where its subsidy commitments are greatest. Only if these difficulties are properly addressed during the current review can the DfT be confident of significantly lower costs and better performance in the months and years to come.

We therefore recommend that the focus of the government's review should be on its relationship with passenger train operators, on putting in place an optimal allocation of risk between the private-sector and the state, and on providing train operating companies with strong, but targeted, incentives to lower costs and improve performance. While other changes to the railway's institutions may be helpful at the margin, they should not be allowed to distract the government's attention from measures which directly enhance the value for money which it receives in exchange for its support to the industry.