Arriva response to The future shape and financing of Network Rail - The scope

November 2015

These comments in response to the scoping report of the Shaw Report are made on behalf of Arriva plc, its subsidiary Arriva UK Trains Limited and its wholly owned train operating companies (TOCs), Arriva Trains Wales/Trenau Arriva Cymru Limited (ATW), DB Regio Tyne & Wear Limited (DBTW), The Chiltern Railway Company Limited (CR), Grand Central Railway Company Limited (GC) and XC Trains Limited (XC), its development company Alliance and its train maintenance subsidiary Arriva Train Care Limited. Arriva is a wholly owned subsidiary of Deutsche Bahn AG (DB AG).

We are pleased to respond to The Shaw Report's consultation on its scoping report and provide our views below on the questions asked.

1. *What are your views on the scope of Network Rail's functions?*

We agree that the roles Operations, Maintenance, Renewals and Enhancement are currently functions of Network Rail. A review of structure and financing needs to establish:

- whether the interaction between these activities is so fundamental and complex that they must necessarily be done by the same organisation;
- the relative arguments for a single entity undertaking these roles on a national basis or having more than one entity for some or all roles; and
- if within the headline of each of the four roles there are in fact non-core activities that could be performed more efficiently by other bodies.

We agree that many of the activities described in section 3.9 under operations do not necessarily have to be performed by the same organisation that undertakes Maintenance, Renewal and Enhancement.

2. *Have we failed to mention any specific and important factors?*

We consider it would be to appropriate to mention other relevant structural solutions, for example:

- joint provision of other industry systems by ATOC under collective ownership of train operators;
- the development of a properly structured System Operator role in the industry;
- review and restructuring of access and other Charges; and
- National Air Traffic Services and arrangements in the electric power industry as models for provision of certain comparable activities.

3. *What are your views on these accountability arrangements and their effectiveness?*

We consider the description of accountability arrangements to be correct, but shows that they are primarily administrative rather than commercial. We consider this a key to understanding why Network Rail has not made the sort of progress in efficiency and performance expected from it and typically achieved in the other regulated utilities.

4. *Have we correctly identified and defined Network Rail's customers?*

We agree that the principal customers are TOCs, FOCs and Governments. We must point out that not all passenger train operators are franchised and for those that are it is a misguided and selective view of their business model to say they are focussed on meeting the terms of their franchise agreements. Our view is that both franchised and open-access train operators are focussed on developing and expanding their businesses, primarily by attracting more passengers. Compliance with contractual commitments, including franchise agreements, is a given.

One issue not identified in the analysis is the extent to which present objectives and incentive structures lead Network Rail to regard the ORR as a quasi-customer and to concentrate on Government and ORR rather than train operators.

5. *How effectively are customer needs and expectations met by Network Rail at present?*

Our view is that the present structure and incentives do not give meeting customers' needs sufficient importance to Network Rail. In most industrial sectors the position of a major wholesale supplier is that its business success depends on selling more and better product to the entities selling direct to consumers. Failure to do so would normally lead to retrenchment, closure or being taken over. The monopoly nature of Network Rail protects it from these pressures and no compensatory incentive regime is in place. We also consider the present approach to renewals and enhancements to be detrimental to the long term interests of the industry and value for money to customers. In most industries renewal requirements are seen as a trigger for debate on what is required for the future, spurred by a desire for continuous improvement. The present framework creates an obsession with restricting renewal to a perception that "like for like" is sufficient and compartmentalising enhancement into stand-alone projects.

6. *Should direct customer pressure on Network Rail be strengthened? If so, how might this be achieved?*

We would argue that it is not just customer pressure but commercial pressure that needs to be strengthened. There are three mechanisms that can help achieve this:

- More of Network Rail's funding for operations, maintenance and renewals should flow though the train operators, but crucially not be automatically direct debited whatever the outcome but be more aligned to the volume and quality of paths provided.
- Competition in the provision of infrastructure management activity, whether in the market, for the market or by comparison should be introduced to the extent feasible.
- Outputs required by Governments and other competent authorities that are additional to or different from the commercial railway should be clearly identified and funded separately from train operators' payments. This may well encompass much of the enhancement programme.

7. *Are there more positive incentives for delivery which would be useful? Are any of these incentives more effective than others?*

As a first step, it is necessary to align objectives and then establish appropriate incentive structures. Financial incentives are problematic in the absence of a structure of shareholders able to respond to such pressures in their direction of the organisation. However, more could be done to align senior management bonus schemes with delivery of required direct and indirect customer outputs.

Reputational incentives would be strengthened in structures with entities having sufficient separation for competition by comparison. There would also be merit in adapting charging structures so that expansion of the railway business created a benefit to the infrastructure manager to incentivise it to enable that outcome.

8. *Is there a case for changing the route structure and what are the advantages and disadvantages of different approaches to disaggregating the network, for example on the basis of:*

■*physical, political or economic geographies?*

■*service type, e.g. commuter services, inter-city services and regional services?*

We consider Great Britain too large for efficient and effective management of railway infrastructure through a single centralised management structure and that a decentralised or plural structure is preferable. However, we recognise there is no simple answer to the question of the best form of disaggregation and this must represent a compromise between markets, political boundaries, technological features, history and geography. We also recognise that the cost of change and corporate inertia has created a structure still showing strong traces of management structures going back decades.

We cite as an example management of infrastructure in Wales. We recognised when awarded the Wales and Borders Franchise in 2003 the many benefits that would arise from a Welsh Route, aligned with both the principal TOC and devolved government. It took us seven years to persuade Network Rail to change to this model rather than a structure based on routes radiating out from London, but the benefits in performance and other areas of cooperation have been significant. It must be noted however that “railway Wales” cannot be the same as the political boundary as the only north-south line is partly in England. We see similar arguments now applying to the “Northern Powerhouse”.

We note that network operation must be based on signalling control areas. These are at present signal boxes and are migrating to Regional Operating Centres (ROCs). Obviously lines or areas could be moved between these in the future, but at a cost. We note, however, that ROCs do not necessarily have to be managed by the same entity responsible for maintenance and renewal, which could be one of the occupants, like the TOCs.

9. *Does the current balance of responsibilities between the routes and the centre seem at the right level? Are there any further responsibilities that should be devolved or centralised?*

Whilst there has been some decentralisation in recent years we still see Network Rail as excessively centralised. This has been demonstrated by ORR’s annual analysis of TOC and Network Rail costs, which has been forced into quite crude allocation of a very large proportion of industry costs. The lack of local responsibility and authority has also tended to slow decision making and restrict cooperative working between Routes and TOCs. We believe Routes, in some cases with re-mapping, should be much closer to stand-alone businesses.

10. *Can you point to any specific economies of scale that should be protected at national rather than route level?*

There is considerable confusion over whether some activities are centralised of necessity or in the interests of economies of scale, and if the latter, whether such economies actually exist. There is a further relevant question that, even if it is more economical to provide a single centralised activity, should it necessarily be an activity of a headquarters function of a national infrastructure manager or would it be more efficiently provided as, for example, a properly structured system operator role, jointly owner service company or jointly procured supply contract. We believe that giving the Route Managing Directors responsibility to determine whether a central supply was value for money or not would flush out many of these issues.

11. *What processes and capabilities need to be in place (at both the centre and route level) to support Network Rail's current devolved structure?*

It is important to distinguish between centralised processes that exist because of the nature of the railway industry as opposed to those that arise from common ownership. We suggest the main effort is put into identifying the former and considering appropriate frameworks to retain the current benefits.

It is certainly important that a central function undertakes or at least coordinates planning of the timetable of the principal long-distance routes to enable the long-distance operators such as CrossCountry and the FOCs to manage their businesses. It may be cost-effective for a national body undertaking such a role to plan the timetable for all other services too, but this needs to be demonstrated. Consideration could be given to address strategic or base timetabling in a different manner to day to day tactical timetabling activity.

A national planning function does now exist at Milton Keynes, however, we do not believe this function achieves a standard to justify exemption from review. Network Rail has struggled to find enough skilled employees at this location, to develop from simply adding together TOC timetable bids to flexing and creating paths and to coordinate engineering access to minimise impact on passengers. It would be advantageous to look at a new management structure for timetable planning, perhaps under the Rail Delivery Group, and to consider a more hierarchical and decentralised approach.

12. *Drawing on your previous experiences where relevant, what would be the potential impact on your organisation of further structural change within Network Rail?*

Reorganisations from time to time have been a feature of the railway industry for many years and whilst concern is often expressed that they will have adverse consequences, we are unaware of any clear evidence for this. In contrast we consider that struggling on with a structure that is not delivering does more harm in that it creates a widespread impression that poor is good enough. Clearly it is necessary for changes to be properly assessed and communicated to avoid introducing risk, but the direction of change is to smaller and more accountable units we have generally found this to be a successful approach.

13. *What are the strengths and weaknesses of Network Rail's current approach to planning enhancements?*

We see five serious weaknesses in planning of enhancements:

- They are typically considered as an activity independent of renewal.
- The GRIP procedure imposes disproportionate costs on small projects, leading to a great many being dismissed when they could have been developed cost-effectively if aligned to maintenance and renewal.
- The approach of allowing a return on the assessed efficient implementation cost introduces a disconnect from the benefits, which discourages value engineering, challenging standards and tailoring investment to maximise industry revenue. It encourages the perception of ORR as customer to be persuaded that costs are efficient.
- The tendency to define enhancements in terms of physical structures rather than operational or commercial outcomes reduces the clarity of what individual projects are intended to deliver reduces the opportunity to review the success of projects.
- Network Rail's poor level of skills in commercial timetable planning and optimising use of capacity often lead to network enhancements with no clear plan for how they will be used or assurance that they represented the best investment. The fact that many enhancements are specified by Government on a similar basis compounds the problem.

14. *What are the strengths and weaknesses of Network Rail's current approach to delivering enhancements?*

Network Rail has made useful progress in developing or adopting from other industries more alliance-based contractual models and has significant expertise in complex projects on live railways. However, we also see significant weaknesses:

- The single monopoly project structure deprives the industry of the benefits of competition when the volume of work is now clearly sufficient to support a more plural approach.
- Processes and standards are still seen by contractors as slow and inflexible, leading to the concept of a "Network Rail price" for a job that incorporates all the on-costs the suppliers have learned from experience will arise.
- A near-monopsony of railway work has destabilised the supply industry and led to insufficient sensitivity to the market.
- A lack of interest and customer-focus in pursuing projects for third-party funders, including open access operators.
- The manifest barriers set up by Network Rail to the delivery of projects by parties other than Network Rail itself.

15. *How well do the current delivery and planning processes work for projects of different sizes?*

The GRIP procedure imposes disproportionate costs on small projects, leading to a great many being dismissed when they could have been developed cost-effectively if aligned to maintenance and renewal and if incentives existed for continuous improvement.

For larger projects the main problem is detachment from both train operators and Network Rail Route management, such that delivery becomes an end in itself rather than a means to provide a better railway. We have experience from a number of projects, for example Cardiff re-signalling, where this has led to anticipated outcomes not being delivered, equipment installed that does not work or nobody being trained to maintain new equipment.

16. *Are there any useful models or precedents from other sectors or countries for long term infrastructure planning and delivery processes that we should consider, including in relation to management of and engagement with suppliers during the planning process?*

We suggest the most appropriate example is actually within the GB rail industry in the manner our Chiltern franchise has developed its business over the last 20 years. A series of infrastructure upgrades have been designed and built to provide very specific timetable enhancements in terms of frequency, capacity, journey time to Birmingham and a new line to Oxford, such that increased passenger revenue has met the enhancement costs. A variety of delivery models has been used, all involving both Chiltern and Railtrack/Network Rail. Whilst Network Rail has chosen to purchase these assets, the approach could have encompassed external funding.

17. *What would be the most important structural features of any future infrastructure provider?*

The most important feature is that they should have strong incentives to maximise and sell good quality train paths.

18. *Are there any other processes which we have not highlighted, either within Network Rail or the wider industry, which could be improved?*

Little mention is made of Schedule 4 compensation. We understand this had two purposes, firstly, to enable franchise bidders to bid without taking risk on the scale of future engineering work affecting their revenues and costs and, secondly, to create a trade-off to optimise access for engineering against the revenue earning potential of the network. We consider it has been generally effective in the first purpose, but has not achieved the second. There are two reasons for this:

- Network Rail conceded during the last Periodic Review that it only considers Schedule 4 implications for around 10% of planned possessions; and
- the discount available for booking possessions more than two years in the future creates an incentive to bank possessions, which may then be used inefficiently or sometimes not at all.

We consider a fresh look is needed at this regime, potentially aligned to a change in which the infrastructure manager is bidding for access to an arms-length or independent body, just as TOCs and FOCs must now.

At the same time, a review of the operation of the Network Change processes would be of benefit for similar reasons.

19. *Do you have any views on how the relationship between the periodic review process and other processes with which you are involved could be improved?*

We consider more attention needs to be given to the behaviours that objectives set and associated incentive regimes and charging structures will generate. More specifically, we would like to see the next Periodic Review create clearer incentives to identify and sell train paths and to optimise the level of engineering access compared with revenue foregone.

20. *What criteria should be used to assess structural options under consideration? How, if at all, should these criteria be prioritised?*

We consider structural options should be tested for:

1. the extent they introduce competition in the market, for the market and by comparison into the monopoly parts of the industry; and
2. whether they create aligned objectives and incentives between industry parties to achieve an expanding and high-performing railway.

21. *Do you have any views on whether the RAB remains a relevant concept in the Railway, and, if not, what should replace it?*

The single RAB within a wholly state-owned infrastructure manager is probably not a useful concept. We also consider it is in danger of becoming a misleading construct as much of it arises from projects specified by Government to achieve wider economic benefits; in effect a Public Service Obligation without a clear funding stream. We can, however, envisage RAB(s) may become appropriate again if a more diverse model emerges.

22. *How should financial risk be managed in Britain's rail infrastructure in the future?*

Risk must be shared between the parties that create it or who are best able to manage it. Hence political and planning risk should generally rest with specifying Governments, whilst project management, design and construction risks should be with an alliance structure appropriate to the project. A variety of parties could address utilisation risk.

23. *Do you have any views on how Britain's railway infrastructure should be funded in the future, regardless of corporate structure?*

There is now a substantial core of the passenger railway that is or could be fully funded by its passengers. However the railway has substantial wider economic benefits warranting regulation and public funding of, for example:

- commuter and social networks;
- expansion of capacity to stimulate economic activity; and
- long-run maintenance, renewals and enhancements necessary for freight services that would otherwise transfer to roads.

We favour creating a model that combines a market-led approach in which train operators fund the infrastructure manager through charging structures that align incentives and behaviours with Government specification and funding of projects.

24. *What positive case studies are there (e.g. international examples in the railway sector, other sectors internationally/in the UK), where more affordable and sustainable funding and financing structures have been implemented, with or without private sector capital input? And how do you think the lessons learnt could be applicable to Britain's railway infrastructure?*

Most countries are struggling with these issues and with the parallel task of identifying and funding the appropriate long-term spend on rail infrastructure. We note that the British model of franchising almost all services, including many able to pay a premium, is unique and most countries have a much larger open-access (or similar) sector. We are aware the CMA is investigating this issue.

25. *What are your views on the enabling factors facilitating a sustainable and affordable capital structure for Britain's railway infrastructure? What factors would be required specifically for private sector capital introduction?*

We consider Network Rail is too large and diverse, with inadequate asset knowledge and records, to easily introduce private sector capital to the entity in its present form. However, we consider smaller entities would be attractive for such investors and could be created by geographic and/or or functional division.

26. *What are the types of investors that may be interested in investing in Network Rail, any of its functions, or in select parts of it? And for these types of investors, can you indicate:*

■*key attractions;*

■*risk appetite;*

■*required enabling factors.*

We believe there are two types of investor most likely to be interested.

- Train operators. These would look for tenure appropriate to asset lives, the ability to achieve targeted investments relevant to growing their business and are likely to take risk on revenue.
- Infrastructure funds. These are likely to content with a regulated return and may prefer to step into projects once complete, i.e. avoiding planning, design and construction risk.

27. *What characteristics do you think enhancement projects would need to have to attract private sector investment and to what extent and in what form would public sector support would be needed? What types of financing structure could be brought to bear?*

This partly depends on the type of investor as suggested under question 26. However, it is likely either type would look for sound asset records, the ability to draw a known boundary around their responsibilities and avoiding major planning risk (Hybrid or Private Bills, major TWA Orders, etc).

28. *What incentive mechanics or control structures on Network Rail would facilitate third party involvement in the financing of enhancement projects?*

Investors would wish to see Network Rail's asset protection or long-term ownership powers preferably removed or at least subject to more transparent and neutral standards.

29. *Do these feel like the right concerns? Has anything been missed that it is vital to consider at this stage?*

We believe the study is engaging with the right issues and would be happy to participate further.