SMF Social Market Foundation

The future shape and financing of Network Rail

Response from the Social Market Foundation, December 2015

Introduction

The Social Market Foundation (SMF) welcomes the opportunity to respond to this review on the future role and function of Network Rail (NR). Our comments focus on the potential options for reforming NR based on unpublished SMF research conducted in 2015.

The SMF agrees with the Review's assessment that there are significant limitations to NR's current operating model. We agree with the principal problems identified by the Review, including poor interfaces between NR and other stakeholders. We would also emphasise the significance of the implications of the reclassification of NR to the public sector.

In discussing and recommending reform, we note four background contextual factors:

- Britain does not have one railway network but many.[1] Different parts of the network display different characteristics. This variation means that the role played by the infrastructure manager may be expected to vary accordingly.

- Given that we would neither expect nor desire competitors to build new tracks parallel to existing rail lines in the UK, the track is naturally monopolistic in most places. This means that there is no competitive pressure in track provision.

- Competition between different train companies on the same track – the subject of an on-going CMA inquiry into greater Open Access competition in rail – may be able to expand marginally but is necessarily limited given the limited space on the UK's rail tracks and the existing (and worsening) capacity constraints. 'Competition for the market' rather than 'competition in the market' is, therefore, likely to remain the chief organising principle.

- The benefits of the market can only be secured if providers of rail services (track and train) have sufficient incentives and flexibilities to respond to demand, to innovate and to improve quality and reduce costs.

Network Rail's structure and accountability *(Review questions 3 to 7)*

Accountability in rail and Network Rail's customers

The SMF's starting position is that the over-riding objective for the accountability and management of railway infrastructure is that as far as possible decisions should be demand-led. In other words, decisions should be informed by what current passengers and future passengers (and freight customers) want and are prepared to pay for, whilst also being accountable and cost efficient.

This objective is acknowledged in the Review: 'providing the relationships between NR, the DfT, Transport Scotland, TOCs and FOCs are functioning as they should, customer pressure from those ultimately using and funding the railway should be passed through to inform NR's decision-making processes.' However, many things obstruct this decision-making hierarchy.

The inherent limitations of vertical separation

As noted above, there is no competitive pressure in the provision of track. In this context, the fundamental accountability dilemma in Britain's rail is the vertical separation between NR and the Train Operating Companies (TOCs). This structure leads to poorly-aligned incentives, the consequences of which are a lack of clarity around responsibilities and an inability to innovate in the best interests of passengers. Split accountability means that there is little incentive on the monopoly track manager and train operators to collaborate and to coordinate investments and improvements that would be in the interests of passengers on the line. The McNulty report concluded that this leads to significant inefficiencies.[2]

As the Review notes, the strength of the regulator relative to the TOCs means that NR may have a natural motivation to treat ORR as its main customer rather than the TOCs and, therefore, to put insufficient weight on passenger needs.

Attempts have been made to overcome this poor alignment. However, only very modest advances have been made and the prospects for future gains seem marginal within the existing structure:

- The Government's decision to direct funding via the franchise operators rather than via direct grant to NR is likely to increase the influence of, and accountability to, TOCs. In turn, this should make NR more demand-focused and customer-focused because such a move would make the subsidy more transparent, may encourage a more commercial relationship between NR and the operators and would send market signals for where more investment is needed. At the outset of privatisation this was the intention so that operators would pay a market rate for access to the track.[3] However, there will still be the same need to regulate prices, train and times and other aspects of the service. In short, it will aid transparency but do little to alter the underlying incentives at play because track provision is still a monopoly.

- The Review cites a small number of alliances between train operators and NR. Such initiatives have been neither widespread nor indeed uniformly successful where they have been attempted. For instance, the joint working between South West Trains and NR in Wessex has faltered. Given that such partnerships are the exception rather than the rule suggests that they may be the product of enlightened leadership rather than processes that could be replicated more widely across the network.

- A recent initiative – the 'Route-based Efficiency Benefit Scheme' – aims to share the upside and downside risks of efficiency measures between NR and train operators.[4] Theoretically this could deliver some benefits, but the scant evidence of voluntary partnership suggests that the outcomes may be limited.

- As the Review notes, the delivery incentives that can be imposed on NR are financial and reputational. Financial incentives include compensation to operators where NR actions cause costs to these providers; fines issued by ORR for failure to meet obligations and penalties for overspending. However, it is unclear how financial penalties can have any bite with NR now that it is classified as a public body.

These disbenefits from vertical separation are not counterweighed by equivalent benefits in the current system. For instance, vertical separation may be beneficial where there is significant on-track competition between different train companies. On many routes this does not appear to be a reasonable prospect. Vertical separation also allows for competition for the market for the provision of train services by TOCs, but this competition could potentially be retained and deepened under alternative commissioning approaches.

If the government is reforming NR, it should reform it so that this fundamental problem of alignment is removed as far as possible.

Alternatives to the current structure

Potential advantages of the concession model

Due to the inherent limitations of vertical separation, the wholesale privatisation of NR would be an undesirable outcome. It would simply perpetuate the current disjuncture in a different guise because provision of track would still be a monopoly.

Instead, where conditions on specific routes are conducive, the Government should seek to use the concession model thus giving responsibilities for track and train to one organisation for a designated period of time. This would reduce the need for regulation (at the interface) during the lifetime of the contract because the interests of track and train would be the same. It would also open the provision of rail infrastructure services to competitive pressure with firms bidding to provide track and train services.

Although the evidence suggests that the benefits of vertical integration do not always outweigh the disbenefits, LEK's analysis for the McNulty report attributed potential efficiencies to this approach in a number of UK geographies.[5] Empirical studies have also found that 'for more densely used railways and those with a higher proportion of freight traffic' vertical integrationreduces costs.[6] This has been ascribed to the fact that co-ordination costs increase more sharply as train density increases and that these co-ordination problems are harder to manage in vertically-separated networks.[7]

Suitable lines are likely to be those where capacity is stretched and where there is clear separation from the rest of the network.

Adopting such reforms would mean addressing some standard objections and challenges to the concession model. First, the government would need to find ways of ensuring that infrastructure was returned in a reasonable state at the end of the contract,[8] so as to ensure that concession-holders do not have an incentive simply to run down the value of the asset over the course of the contract.

Second, the number of competitors bidding to run the concession would be expected to be lower than for a current franchise contract given that providers would have to bear a higher level of risk.For instance, the government would be likely to demand higher capital guarantees from potential providers. The theory is borne out by empirical evidence from the German rail industry. This showed that the higher the percentage of risk assumed by the commissioner for price increases on input factors like personnel or fuel, the higher the number of bidders. In addition, the higher the level of revenue risk outsourced to the provider, the lower the number of bidders.[9] Therefore, the government may have to take steps to help develop the market. However, international evidence on concessions and, indeed, the experience of HS1 showed that the market can function well given the right conditions.

Third, if bidders are required to take on responsibility for track as well as train, contracts will need to be longer given the capital intensity of track investments and the long payback periods. This would mean fewer instances of competition at bidding points and therefore the need for stronger incentives for providers to increase value for money during the life of the contract. The SMF will be publishing a paper on rail franchising in January which will set out how franchise holders (and in turn those who hold the concession) can be rewarded for achieving targets during the life of the contract and given additional freedom to innovate and respond to passenger demand.

Finally, this model is unlikely to work across the whole network, especially where track could be shared between different providers. As described below, this may mean that provision of track becomes more diverse.

Opportunity for diversity of approaches
As noted above, the concession model would not be appropriate for all parts of Britain's network. In these other areas, we would propose a mix of:

- Devolution of responsibilities to democratically-accountable transport decision-making bodies such as Transport for the North and Merseyrail at the sub-regional level. The current Government is planning to increase devolution to cities in a number of areas, including local transport.[10]

  In one sense, devolution simply delegates the question of whether to run a vertically-integrated or vertically-separated rail system. The local commissioner could decide to run a concession or to separate out the functions. However, there may be benefits. The local commissioner would be closer to passenger demand than national commissioners and arguably better-placed to coordinate investments between different stakeholders. Second, such initiatives have the additional advantage of facilitating integration across transport modes by combining accountability for a wider suite of transport services in one authority (e.g. buses as well as trains) as well as placing decision-making in closer proximity to other enablers of integrated transport (such as local planning regulation).[11] The most ambitious manifestation of this is Transport for the North which is combining the accountability of the Passenger Transport Executives and other local authorities to take responsibility for all transport services in the north of England.[12] Clearly, however, the principle only holds where the large majority of journeys are intra-regional otherwise accountability to the consumers of the services is unfulfilled.

- Where neither a concession model nor devolution is appropriate, the state operator should retain control of the track infrastructure. In such instances, the successor of NR would manage the infrastructure in a given area.

Enabling this diversity could have wider benefits, including

1. It would seek to ensure that structure follows function and that the variation in the UK's network is reflected in variation in management. Seeking to have a homogenous approach across the UK does not recognise the variation in the rail network and services.
2. One of the current problems of regulation is assessing what charges TOCs should pay and making reasonable estimations of what levels of efficiency are achievable. Greater diversity would enable benchmarking and therefore more informed future decision-making.
3. Moving to concessions is likely to make extra demands of bidders who are likely to need a larger scale than many current TOCs. Diversity would enable the market to develop and for providers to escalate from running train services up to playing roles in concession bids.
4. With the prospect of greater technological innovation in the future, diversity would allow a wider number of approaches to be tested across the network.

Financing and funding *(Questions 21 to 28)*

The Review's observation that funding should follow structure is reasonable as a starting position. It may, however, overlook the fundamental importance of the decision on financing. One of the principal benefits of relying on a Regulated Asset Base model is that investment decisions are subject to the discipline of the market rather than the shorter-term horizons of politicians and governments. The latter often leads to putting off infrastructure investment for more popular expenditure today. The same motivation may also encourage expenditure on visible improvements and *grand projets* over less noticeable (though no less necessary) types of improvement.

This desire that investment decisions are informed by the market rather than short-term political considerations is an entirely logical rationale behind using private finance and it is completely different from the motivation that may exist for governments to score investments off-balance-sheet rather than on the public balance sheet.

Given that NR's liabilities now score on the public balance sheet, investment decisions are now once more susceptible to the pressures discussed above. The current arms-length structure of NR achieves neither the advantages of full incorporation (to the extent that control can be exercised easily with transparent democratic accountability) nor independence from political decision-making.

Therefore, the SMF would suggest that any reform should recognise the potential advantages of private finance.

Strategy-making

Objective-setting in rail is spread thinly across a range of organisations, including NR, the Department for Transport and ORR. Partly as a consequence of this, strategy-making remains too fragmented, too focussed on the details of delivery and too opaque. For instance, as part of our research, we heard some concerns that balancing both the immediate maintenance needs of the network with the long-term strategic direction of the network is an almost impossible task for NR. Another symptom is that there is insufficient clarity on why rail is subsidised and which aspects of rail should be subsidised.[13]

In so far as decisions are not informed by the market, we would echo criticisms from quarters such as the Campaign for Better Transport that rail strategy is isolated from other modes of transport and that policymakers should concentrate on 'a route-based transport strategy' rather than a rail one.[14] The House of Commons Transport Select Committee has championed this cause, calling for 'a clear and comprehensive strategy for transport'.[15] Professor Dieter Helm has put it most bluntly: 'There is no overarching transport policy'.[16]

It would be preferable to have a strategy-making body that was able to look at future rail demand and services, and at how rail services interact with other modes. For instance, there would be merit in ensuring that rail investment strategy is developed in parallel and over the same time horizon as the road investment strategy. Such objective-setting should be focused on transport in the round and should establish the specific future of rail services over the next twenty-five years.

About the Social Market Foundation

The Social Market Foundation (SMF) is an independent public policy think tank. We are not politically aligned and have members from across the political spectrum on our Board of Trustees and Advisory Panel. Our work spans public service reform and the social market economy, and champions ideas that marry a pro-market orientation with concern for social justice. Since its inception in 1989, the SMF has gained an enviable reputation for the rigour of its research, driving policy debate based on sound argument and clear evidence.

To contact the SMF about this submission please contact Nigel Keohane, Research Director, at the SMF: [contact details redacted]

Endnotes

[1] See for instance, ORR, *GB rail industry financial information 2013-14* (February 2015)
[2] Sir Roy McNulty, *Realising the Potential of GB Rail: Final Independent Report of the Rail Value for Money Study - Detailed Report* (2011)
[3] Andrew Bowman, *An illusion of success: The consequences of British rail privatisation*,
[4] ORR, *Route-based efficiency benefit share* (2012)
[5] Rail VfM Alternative Railway Structures: Final Report – Volume 2 07 March 2011
[6] Chris Nash, Andrew Smith, Didier van de Velde, Fumitoshi Mizutaniand Shuji Uranishi, 'Structural reforms in the railways: incentive misalignment and cost implications', *Research in Transportation Economics* (2014)
[7] Fumitoshi Mizutani, Andrew Smith, Chris Nash and Shuji Uranishi, 'Comparing the Costs of Vertical Separation, Integration, and Intermediate Organisational Structures in European and East Asian Railways', *Journal of Transport Economics and Policy*, 2014
[8] See, Dft and ORR, *Rail Value for Money Study - Research Project on unit costs and franchising: RVfM 10002* (2011). It should be noted that there are vertically-integrated networks in London and on HS1.
[9] Arne Beck, 'Barriers to Entry in Rail Passenger Services: Empirical Evidence for Tendering Procedures in Germany', *Center for Network Industries and Infrastructure, Working Paper* No. 2010-02, 2010.
[10] https://www.gov.uk/government/speeches/chancellor-on-building-a-northern-powerhouse
[11]Nigel Keohane, *On the Right Track* (NLGN, 2010).

[12] Campaign for Better Transport, *Northern Rail: Stepping Stones to a rebalanced Britain* (2015); HMG, *The Northern Powerhouse: One Agenda, One Economy, One North* (2015)
[13] House of Commons Transport Select Committee, *Rail 2020*
[14] For instance, see Campaign for Better Transport evidence to Select Committee
[15] House of Commons Transport Select Committee, *Investing in the railway* (2015)
[16] Professor Dieter Helm, *What to do about the railways?* (2015)