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Sanctuary Buildings
Great Smith Street
London
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Your ref:

Our ref:

Date:
21 December 2015

Dear Nicola,

The future shape and financing of Network Rail – The scope

Thank you for the opportunity to respond to your scope report.

The executively devolved arrangements for Scotland's railways have been in place for nearly ten years now. Much progress has been made in this time, with a rail strategy in place that fully aligns with Scottish Government objectives, successful creation of rail franchise provisions and record levels of investment made to support a transformative change to Scottish rail services, including the recent re-opening of the Borders railway.

The industry itself is at a critical juncture. We've seen a number of changes in railway structures, most notably: the decentralisation of operational decisions to the Network Rail routes; the emergence of Alliances and other forms of collaborative working; and the reclassification of Network Rail as a central government body.

Both the Hendy and Bowe reviews have just concluded and, along with the outcomes from your review, this means that changes to the future structure of Network Rail and the wider industry are an inevitability. From the perspective of the Scottish Government, this represents an opportunity to make a step change in the quality and efficiency of Scottish rail services through the full devolution of Network Rail in Scotland, which will improve accountability and collaboration for the benefit of passengers and freight customers. Our ministers welcomed the opportunity to meet you in person earlier this year to share their views which are consistent with what is set out in this letter. At official level we also participated in a very good workshop session the Review Team chaired in Glasgow.

Rail industry in Scotland and the role of the Scottish Government

The Scottish Government's updated Economic Strategy focuses on the two mutually supportive goals of increasing competitiveness and tackling inequality and we have four priorities in which we believe our actions can make a substantial difference:



- Investing in our people and our infrastructure in a sustainable way;
- Fostering a culture of innovation and research and development;
- Promoting inclusive growth and creating opportunity through a fair and inclusive jobs market and regional cohesion; and
- Promoting Scotland on the international stage to boost our trade and investment, influence and networks.

The rail industry has a critical role to play in Scotland's economic and social wellbeing by delivering high quality passenger and freight services which:

- are attuned to Scotland's needs;
- are efficient and represent good value for money for passengers, freight customers and taxpayers;
- support our businesses and communities by connecting towns, cities and rural areas;
- increase the reach of Scotland's businesses through efficient, reliable connections across Scotland, the UK and internationally;
- help to make Scotland an attractive place to do business and invest;
- support a greener Scotland by offering real alternatives to road and air travel, including the transportation of goods; and
- allow our citizens and visitors alike to enjoy Scotland's stunning landscapes and rich cultural heritage.

Growth and investment on Scotland's railways

Renaissance is a word often used to describe recent railway growth trends and in Scotland's case it is very apt. We have seen an increase of 45% in passenger journeys in the last decade, to around 93 million, levels of reliability generally improving against a backdrop of significant increases in services, and passenger satisfaction levels have been consistently higher than the rest of the UK, averaging at around 88%.

This has not been by coincidence. Since 2007 over £6 billion has been committed by the Scottish Government to improvements in rail infrastructure and services, supporting new fleets of modern electric trains, new and improved services through the ScotRail and now Caledonian Sleeper franchises, the delivery of 76 kilometres of new railways, and the opening of 13 new stations (including seven new stations that were introduced upon completion of the Borders Railway in September 2015 – the longest new domestic railway to be constructed in Britain for over 100 years).

On the back of this success we anticipate that demand for rail travel in Scotland will continue to grow and that's why a further £5 billion programme was committed to 2019, including £3.5 billion capital investment in the infrastructure. This will support the delivery of new electrified routes between Glasgow and Edinburgh via Falkirk High and Shotts and to Stirling, Alloa and Dunblane, as well as substantial improvements between Aberdeen and Inverness and between Inverness and the central belt.

The scope of your report

I thought it useful to offer a few observations on the scope of your report (the terms of reference).

The customer perspective

We have a very clear position that passengers and freight customers should be at the heart of all that we do on our railways. While on the face of it, Network Rail has a more indirect relationship with rail users, the ScotRail Alliance is demonstrating that this need not be the case and that there is the potential for significant improvements in the delivery of services where incentives across the rail industry are completely aligned, particularly at a local level. An integrated organisation with common objectives is making a real difference to passengers and improving efficiency through whole industry solutions.

Therefore, a focus of your review should be to ensure that the interface between Network Rail and other parts of the industry are as seamless as possible for the benefit of passengers and rail freight customers. This means that the scope of your review should go beyond the role of Network Rail where that is necessary to achieve meaningful whole industry change.

The Scottish Ministers also have a very clear view that our railways are an integral part of the Scottish public service landscape, fulfilling a vital social and in some cases lifeline services for our communities. This is reflected in the level of public subsidy paid by the Scottish Government, which is around £5bn over the life of CP5. Given this, the Scottish Ministers are very clear that they would not accept any proposal to reprivatise Network Rail in Scotland. Moreover, the success of the rail industry should not be measured in narrow industry terms, but in the broader contribution to the economic and social vitality of the community it serves.

The devolution perspective

When considering railway structures across GB, both in terms of Network Rail and the wider industry, it is of critical importance to keep in mind the statutory role of the Scottish Ministers. This is something that was perhaps not fully captured in your scope report. In summary, the Scottish Ministers have a duty to undertake the same functions for Scotland as the Secretary of State for Transport in relation to railways in England and Wales. Also of importance is the functional role of Transport Scotland, who has a close and productive relationship with all areas of the Scottish and GB rail system.

The Railways Act 2005 sets out the majority of the Scottish Ministers' rail powers. On the coming into force of the Act, the Scottish Ministers assumed responsibility for a number of areas, including:

- Setting a strategy for Scotland's railways, incorporating freight and passenger services.
- The role of franchising authority for Scottish Franchise Agreements. This means specifying which services are to be provided under franchise, contracting for, managing and funding the provision of those services. The manifestation of these powers is the ScotRail and Caledonian Sleeper franchises, the current versions of which came into operation in April this year.
- Specifying and funding outputs for Network Rail in the management (including performance) and enhancement of the infrastructure on the Scottish route. This is currently brought to life through the HLOS and SoFA, which is the key input into the ORR's Periodic Review.
- Issuing non-binding Guidance to the ORR, which outlines the expectations of the Scottish Ministers' on how the regulator will carry out their duties in Scotland.

But devolution in Scotland goes far wider than the powers enabled through the 2005 Act: the consequence of the statutory changes has led to the devolution of a suite of 'working-level' arrangements, which has enhanced the delivery of railways in Scotland:

- The creation of the Network Rail Scottish operating route, with an increasing degree of operational autonomy devolved over time. This has brought about a number of benefits, in particular it has enabled a strengthening of local relationships and, in some areas, more coherent decision making process. This is most visible through the ScotRail Alliance - now unique in GB railways - which is bringing infrastructure management and service delivery together to deliver transformative change to the quality and provision of services by placing passengers' needs at the centre of railway thinking.
- A much closer working relationship between Scottish Government Ministers – delivered at a working level through Transport Scotland - with Network Rail (primarily through the ScotRail Alliance) and the ORR on delivery and performance issues in Scotland.
- Separate, enforceable outputs and funding settlement for Scotland through the ORR's periodic review, supported by a distinct strategic planning process.
- Post reclassification, the Scottish Ministers have a formal role in a range of matters relating to Network Rail's finances and governance as they affect the Scottish route. This includes senior appointments and business planning. Aligned to this is a separate Scottish debt limit to cover Network Rail's borrowing requirements for CP5.
- Scotland's railways are very much seen as an essential public service. This has had positive effect by placing rail services in a prominent position when considering policy options to support economic growth and social cohesion. However, it has also created a broader perception that ultimate political accountability for all rail matters, including Network Rail, lies with the Scottish Government. This has led to a mismatch between public expectations and the reality of the current railway structures and means that the Scottish Government has not always been able to act in the best interests of the people of Scotland.

As we discussed during our recent meeting, we are of the view that the current devolved arrangements can be strengthened for the benefit of rail users in Scotland, cross-border services and the other Network Rail routes across GB. I will cover this in more detail later in this letter.

The growth perspective

As outlined earlier, Scotland's railways currently bask in a period of unprecedented growth and we see this continuing for the foreseeable future. The recently published draft Scotland Route Study predicts considerable growth across the whole network, for example as high as 157% on interurban routes by 2023.

Evidence, such as that presented in the Route Study, clearly demonstrates that our railways have a role to play in facilitating growth through connecting our cities and communities – take the Borders rail line for example - and also in sustaining that growth through meeting increasing demands for more and faster passenger and freight services. This is what drives our decisions on the right investments in services and infrastructure.

A key feature of the planning process for CP5 in Scotland was close collaboration between Transport Scotland and the Scottish rail industry, alongside a shared understanding of Scotland's broader economic and social position and how rail could best support the Scottish Government's strategic outcomes. It is vital that the industry in Scotland is fully equipped to lead on strategic planning in order to provide sound advice to the Scottish Government. Further devolution of Network Rail's planning hierarchy, as it relates to Scotland, would undoubtedly strengthen this for CP6 onwards.

Financing

Despite the obvious successes, there is a recurring theme whereby any Scottish Government decisions on investments or the specification of services has to be taken within a GB-wide framework set by the UK Government. While both governments share many of the same aspirations for railways, there are areas where the priorities are different. In such circumstances, the Scottish Parliament is currently powerless to change the overarching framework for Scotland's railways, and this has become a real barrier to progress. One of the key lessons learned from our Rail 2014 consultation, which ultimately led to the specification for our two franchises, was that our Ministers could not consider all of the options put forward by respondents as a direct consequence of the legislative constraints. For example, the ability of public service providers to bid for Scottish franchise agreements, which is now included in the draft Scotland Bill.

I fully recognise that the consideration of the devolution of Parliamentary powers for rail is out with the scope of this review. However, there are a range of things which can be done to improve the situation within the current legislative framework, primarily the full devolution of the Network Rail Scottish route. This would enable the route to build on its successes and for the ScotRail Alliance and other partnerships to reach their full potential. I would therefore ask that the report give detailed thought to this, and in particular the clear benefits it would bring in the following areas.

Accountability

Network Rail has no formal, direct accountability to the Scottish Parliament or to the Scottish Ministers, despite a public funding contribution of c. £3.5bn in the period 2014-2019. In addition, under the current arrangements, the two main parts of the Scottish rail system i.e. ScotRail and Network Rail, are directly accountable to different governments.

This is clearly an anomalous situation and not in keeping with any other model of public service in Scotland. As has been demonstrated by Scottish Water, which I'll touch on later in this letter, greater, local political and public accountability can improve the performance and responsiveness of public services.

Governance

Post-reclassification, there have been considerable changes at corporate level within Network Rail with the removal of the Members and the appointment of a Special Director. Given this, and despite the recent structural changes announced by Network Rail, there remains a risk that the focus of Network Rail's executive team will be driven by the priorities of its biggest customer and sole shareholder, the Department for Transport. The most straightforward way to mitigate this risk is to have a devolved governance structure for Network Rail in Scotland, which can have a singular focus on the needs of the Scottish route and its customers.

Locally developed, tailored solutions

While tailored solutions have been a successful feature of the current devolved arrangements for Network Rail in Scotland, a considerable number of functions, which are key to the efficient operation and development of the Scottish route, remain centralised, such as asset management strategies, planning, property, timetabling and major projects. While Phil Verster, ScotRail Alliance Managing Director and now Network Rail Managing Director for Scotland, has made good progress in co-opting these teams to create a more integrated approach, the structural separation of these and other HQ functions continue to create a barrier to the Alliance in reaching its full potential. Whilst recent changes may provide some additional discretion to

It is a reasonable assumption to make that the Scottish Government will continue to provide the bulk of funding for rail services in Scotland for the foreseeable future. Therefore, there are a range of financial implications associated with any plans to restructure Network Rail, primarily the treatment of historical debt and the funding arrangements for CP6 onwards.

I note your view that financial modelling should follow your conclusions on the right structure(s). In this context, an issue of note is the future of the Regulatory Asset Base (RAB). The RAB funding methodology, whereby rail enhancement and renewal can be funded through borrowing, has been a fundamental aspect of rail financing over the last decade and was a key part of the financial settlement between the Scottish and UK Governments at the point of the transfer of powers to the Scottish Ministers under the 2005 Act.

The Scottish Government has, in line with its broader approach to financing, ensured that levels of borrowing for rail investments have been sustainable and the RAB to debt ratio for Scotland has historically been much lower than the rest of the GB network. There is however a significant question over the future of the RAB funding methodology as a consequence of Network Rail's reclassification and the transfer of their GB-wide debt to the UK Government balance sheet. While some change may be inevitable from 2019 onwards, the very clear position of the Scottish Ministers is that any new financial arrangements cannot be to the detriment of the Scottish Government's ability to invest sustainably in the Scottish network.

Timeframe for change

I would fully support your plans to apply the recommendations from the start of the next Control Period in 2019. This seems the most obvious, and arguably least disruptive, point to implement any change, and would enable Network Rail to continue to focus on the delivery of the CP5 outputs whilst giving both Governments sufficient lead in time to enable change.

I am less convinced on the rationale to extend the end date for change to 2029. I think this presents a significant risk of creating uncertainty across the industry. I accept that restructure will in some respects be an evolutionary process, particularly around cultural change. However, I would be of the view that Network Rail and the industry should be set challenging timescales, particularly around devolution and closer working, so that rail users can benefit from change as early as possible.

A devolved structure

The devolution of powers under the 2005 Act has enabled the Scottish Government to contribute considerably to the success of Scotland's railways in support of broader economic growth and social cohesion: both in terms of financial investment and helping to build greater collaboration, particularly at a local level.

The ORR's analysis for CP4 and the first year of CP5 has shown that, while Network Rail is still falling below expectations in the delivery of outputs for Scotland, the overall operational and financial performance on the Scottish route is better than the majority of routes in England and Wales. Our view is that this has been driven, at least in part, by the maturity of the devolution on the Network Rail Scotland route which has enabled a clearer alignment of targets and objectives between industry partners.

Better operational and financial performance will be further enhanced through the creation of the ScotRail Alliance. Beyond this, there are good examples of Network Rail Scotland working closely with cross-border operators, whether providing passenger services or freight, to develop the right solutions.

operating routes on which HQ services they will continue to buy in, it remains our view that the default position should be to devolve all operational and strategic Network Rail functions to the route unless there is a strong case to retain them centrally.

A good example of what can be delivered through a locally agreed approach is the Paisley Canal electrification project, which was the first delivered under the original Alliance agreement between Network Rail and First ScotRail. As a consequence of tailored solutions and local collaboration, this was delivered almost three years ahead of the original plans and at less than half (£12m) the anticipated cost of £28m. However, as yet, this approach has not been replicated in the delivery of other projects and there are informal indications from the industry that the main barriers to this relate to the centralised functions. While clearly small in scale, it would be worthwhile exploring whether the Paisley Canal project can act as a template for delivering major projects and other elements, such as maintenance and renewal work, of the Network Rail work programme in Scotland.

Any new arrangements would of course protect the position of cross-border passenger and freight services and we would look to maintain an approach which safeguards the good safety record of our railways.

Speed and effectiveness of response

Many of the critical decisions on the management of the network in Scotland (and the other routes across GB) are either taken by, or require the approval of, Network Rail HQ. This has on occasions led to unnecessary delay, inefficiency and centrally driven solutions not always best suited to local circumstances, particularly around the delivery of major enhancement projects.

While diligence on changes to projects would still be required, a process which is overseen by the Scottish route, working closely with all partners and delivery agents, has the potential to be much more responsive and streamlined. It is worth reflecting that this approach is already being pursued by the ScotRail Alliance, but full devolution would strengthen this further and avoid a reversal of progress if the Alliance structure or its leadership changed.

Benchmarking

Comparative regulation is widely regarded as a key driver of greater efficiency across utilities, and was prominent in the final recommendations in the McNulty Rail Value for Money study. A fully devolved Scottish route would undoubtedly create greater opportunities for benchmarking to the benefit of all of the routes on the network across GB. It would also enable Network Rail in Scotland to compare, contrast and learn from similar-sized networks across Europe and beyond.

Broader comparator

The report asks a number of questions about broader comparators. It would be worthwhile therefore drawing your attention to Scottish Water, which is currently the only public utility which is fully devolved in Scotland. Scottish Water was established as a public sector corporation under the Water Industry (Scotland) Act 2002, formed by the amalgamation of the three regional water and sewage authorities.

Scottish Water has outperformed its regulatory settlement for the period 2010-2015, delivering all of the specified outcomes for £122m less than the financial settlement set by the regulator. Whilst a determined management has played a role in this achievement, the framework put in place by Ministers and the regulator has ensured that Scottish Water has been absolutely clear about the targets and therefore what outperformance looks like. This has been bolstered by

regular and detailed scrutiny by the relevant Scottish parliamentary committee and regular dialogue and oversight by the Scottish Government.

Conclusion

Executive devolution has had a positive effect on Scotland's railways. It has enabled the Scottish Government to specify investment in services and infrastructure which is better attuned to Scotland's socio-economic needs. At a practical level, the decentralisation of decision making within Network Rail in Scotland has supported joined up thinking and partnership action across the industry, while the separate regulatory settlement has meant clearly identifiable and enforceable targets for Scotland.

In many respects, Scotland's railways has led the way in developing whole industry solutions through the Alliance which are designed specifically to meet local challenges. This has undoubtedly been a major factor in the better financial and operational performance on the Scottish route in CP4 and in CP5 to date. However, there are still a number of structural issues which are standing in the way of progress, primarily the extent to which the whole industry can be held accountable on behalf of the people of Scotland, and the freedom of Network Rail in Scotland to work with their partners to take speedy and effective action for the benefit of passengers and freight users.

Through your review, and the conclusions reached by Sir Peter Hendy and Dame Collette Bowe, we are entering a time of change for rail across Great Britain. As laid out in this letter, our Ministers are clear that there is a very strong case for the full devolution of the Network Rail route in Scotland as the next logical step in a journey towards a truly world class railway for Scotland.

I hope this response is useful. If you require any further detail or want to discuss any aspect of the response, in the first instance you should contact John Provan () in my team.

I am copying this letter to Cavendish Elithorn at the Department for Transport, and Steve McMahon and John Provan at Transport Scotland.

yours Sincerely
A. Grisewood

AIDAN GRISEWOOD