BRUG

Bolton Rail Users Group

Working for a Twenty-first Century Rail Experience

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Submission to the Shaw Report Secretariat for Possible Use by Nicola and Others within the Secretariat.

Ideas for possible new structures to facilitate solution of problems etc. discussed by Manchester Working Group on 18 December 2015

<u>The basic idea</u>

Create a new organisation to assume all the present functions of Network Rail, other than those which are proposed for transfer away to some other body. This should mean that the new organisation (let's call it "NewCo" for now) would have at least the functions of owning managing, maintaining, and enhancing the current rail infrastructure (which need to be integrated) and, unless a particular project or project is considered appropriate by the Government to be given to some other body, the constructing of entirely new lines and infrastructure. It could also, but need not, be given responsibility for controlling access.

NewCo would be in the private sector and entirely off the balance sheet of the Government. Any borrowing it undertook would therefore not be constrained by Government economic policies of the time, although of course any grant funding by the Government to it would be.

NewCo would be a shares company but those shares would not be traded – it would be a "private" limited company, not a public one (i.e. a "PLC").

The shares would be held by the bodies who are for the time being the "direct" customers – the rail operating companies, both passenger (whether under franchise or open access) and freight. These would be allocated in proportion to the level of traffic operated, possibly with a formula based primarily on numbers of train movements but with an additional weighting for freight operations because of the greater size and weight of freight trains and their longer average journey length. As operators come and go, franchises change and growth occurs, shares would be surrendered, transferred or redistributed and/or new shares would be created.

The NewCo shareholders would, as is usual in almost any company of some size, normally be not directly involved in management and projects, but would appoint and dismiss directors, including the Chairman, hold them to account and ensure adequate planning, performance management and financial control systems are in place and properly operated at all times. The shareholders would nevertheless be influence "culture" in NewCo, in the sense of behaviours, values, thinking and attitudes, which over time would coalesce with those within the shareholders' own operations

<u>Finance and funding</u>

The financing and funding arrangements allowable to NewCo would be broadly similar to those at present possible for Network Rail. In other words, NewCo be able to obtain revenue from a mixture of train access charges, revenue grants from the Department of Transport and miscellaneous income from commercial operations, e.g. at stations etc. Capital funding for enhancement and new construction would be through Department for Transport grants or borrowing by NewCo from other sources. It would not generally be able to raise new capital by calls on its shareholders or others, rights issues or new public offerings.

NewCo would be required to maintain sound finances. It would have at least to break even on revenue account, taking one year with another. Except for the purpose of the management of cash flow and the maintenance of necessary working balances, it would broadly be precluded from borrowing for any purpose other than capital expenditure on the renewal, enhancement or replacement of fixed assets or the construction or acquisition of new assets. It would however be able to able to distribute surplus income to its shareholders by way of dividends. This would be conditional upon sufficient revenue reserves remaining to allow the company to carry on business and perform its functions and obligations.

Conversely, if NewCo fails to observe the requirement to break even on revenue, there should be an obligation on the shareholders to make good enduring deficits that have accrued.

In this way there will be someone, the shareholders as a group, who have an incentive to ensure NewCo performs and risk a financial penalty if it does not.

With regard to borrowings for capital purposes, the debt should not, as in Network Rail, be allowed to build up continually and never be repaid. There would be a requirement for principal and interest to be repaid out of revenue over a period of 25 or 50 years (depending on the type of the relevant asset) or earlier if the life of the relevant asset is shorter.

Because of the public interest, the public money likely to be involved through grants, whether of a revenue or a capital natures, the large scale use of assets which have previously been obtained or produced through public money, the need for a "neutral" person to be involved to facilitate decision-making where shareholders may have differing interests or issues are in conflict, and to be a "back-stop" to deal with failure that cannot otherwise be resolved or the provision of adequate and acceptable rail services is at risk, the Secretary of State needs to have significant powers. Network Rail, which is fully recognised as public sector and part of the Government's balance sheet and completely controlled by the Secretary of State could be kept in existence as a body to play an important part in this.

<u>Powers of the Secretary of State</u>

These could operate in four different and complementary ways.

The first is through the continuing Network Rail company, which the Secretary of State fully controls, and a long leasing by that company of the property, infrastructure and other assets which it owns to NewCo. This would be instead of a simple transfer outright of those assets to NewCo, whether by legislation or otherwise. would enable a strong mechanism through land law to exercise a necessary degree of control and take back ownership of everything quickly in the event of business failure. This long lease could be for a term of anything from 99 to 999 years and would be at a "peppercorn" (a legal construct meaning effectively a nis rent). This would contain covenants (legally binding and enforceable undertakings) by NewCo to manage, enhance and operate the network and assets properly etc., allowing the sanction of terminating the lease in whole or in part in the event of substantial non-compliance, and requiring permission from Network Rail as freeholder for particular actions including the sale, disposal or otherwise parting with possession of significant assets. A lease would also contain a restrictive covenant on the use of the leased property so that it could only be used for the rail functions of NewCo. This would ensure that all development value or other windfalls benefitted the public purse. The lease would also contain a provision to the effect that it was basically unassignable, but would permit assignment by way of sale of non-vital assets in the ordinary course of business, subject to Nework Rail's permission.

The second is that the Secretary of State would be a member of the company and hold a "Golden Share". This would give him voting power in a general meeting of members of the company. This could be constructed in such a way that he is able to block the passing of what is known as a "Special Resolution". Under company law such a resolution needs a 75% vote in general meetings, is subject to advance notice being given and is required for various important actions, e.g. major company restructure, changing the internal constitution (Articles of Association) and winding up. It would be possible to specify in the Articles that other actions will subject to the 75% voting rule and give the Secretary of State to exercise a veto on them also. In order to defeat the purpose of the new system and take ordinary control away from the rail operators as shareholders in NewCo, the Secretary of State's Golden Share vote would however not be exercisable on most ordinary decision-making by company members.

There is perhaps, but not necessarily, a case for the Secretary of State however, as a shareholder, to be able to participate to some extent in any dividend that NewCo decides to issue, so that the taxpayer is able to receive some payback if the operating companies are receiving a payback. The weight of the Golden Share for dividend purposes would have to be specified in the Articles of the Company. It should not be so large as to take away the incentive for the operating companies to be involved in NewCo as shareholders and, indirectly ensure its profitability.

The third is that every future capital grant made by the Department of Transport to NewCo should be the subject of a detailed funding agreement (or a composite agreement covering a number of projects), setting out what project each grant is for, its specification, timescale and other relevant details, and any other appropriate provisions with regard to going over or under budget etc.

The fourth is that the Secretary of State would need to be the person who undertakes the allocation and transfer of shares that the individual operating companies have and deal with changes or re-mapppings of franchises, future growth and the addition or withdrawal of new or existing open access passenger and freight operators.

Comment

The various elements of the above proposals are designed to facilitate solutions to various issues which the report will be addressing.

The effect of them would be that the essential heart of the present Network Rail functions and their management would be:

- taken out of the public sector and removed from the constraints of the Government's balance sheet, back to the position in which Network Rail used to be treated as being in.
- made subject to effective monitoring and required to perform to budgets and plans
- made accountable both privately and publicly:
  - publicly through the Secretary of State's powers and Network Rail as freeholder under the lease
  - privately through the shareholders (the operating companies), for whom and for whose passengers the infrastructures and services of NewCo will be provided, and who will bear the consequences of recurring failures and receive, perhaps with the Secretary of State, a share in the fruits of consistent outperformance.

The proposals build upon the experience of the South Western Alliance that existed for a time between the franchisee and Network Rail. Bringing operation and infrastructure together at operational level reportedly worked very well indee there. It is thought that Alliance was discontinued only because of different attitudes and approaches at more senior levels within Network Rail from those of the people in both sides at the operational level. The proposals bring both train operators and the network provider together at the top, harmonising and uniting their respective interests, attitudes and behaviours and limiting, or preventing altogether, future dysfunction.

The European Union's Directive for the separation of rail service operation and the management of rail infrastructure needs to be considered. These proposals would mean that the distance between the two would be reduced as compared with now. Whether the separation under these proposals would still be sufficient to comply with the directive is a matter for lawyers with the relevant expertise to advise upon. But if the structures adopted in this regard by the French and German national railway systems (SNCF and DB) are compliant with the Directive, one would have thought that these proposals would also comply.

The proposals produce a fair and workable balance between the public and private sectors. They also allow a bringing together of both passenger and freight operating companies and their needs. The freight companies seem to feel "left out" under the present system and freight is of vital importance to the railways and the economic health of the nation.

The proposals are flexible and would seem to be capable of accommodating and facilitating all or most of the solutions which may conceivably be recommended in the final version of the Shaw report. The current re-organisation of Network Rail into devolved regional units and any the creation of any future Alliance on the South Western or any other model of devolution or localisation can easily be accommodated in the proposals, within NewCo. Between them, NewCo and the operators would in fact be free to develop whatever operational methods, partnerships and alliances and geographical structures may be thought appropriate at any time. The proposals could also accommodate whatever future method of grant aiding or subsidy by the DfT with regard to infrastructure was adopted, by payment to or through the train operators or directly to the infrastructure holder, i.e. in these proposals NewCo. If payment is injected via the operators, the funding agreement would simply be changed to be one between three (or more) parties instead of two.

Implementation

If these proposals, or something on similar lines, were adopted, implementation would take time. But the bulk of the implementation would be means of company creation, contracts, leases and probably shareholder agreements. The only possible requirement for legislation, i.e. the lengthy procedure in Parliament, would be with regard to Network Rail itself. It is not being abolished. Rather its functions and property are being devolved and performed in a different way. There is legislation covering Network Rail. Whether the devolution of functions in this way is permissible under that legislation is a matter for lawyers. But if there has to be legislation, it ought not to be very complex.

Clearly, however, even if legislation were not required for these proposals, if they were to be implemented, it would be only right that they were debated in some way in Parliament and there would obviously need to be full and detailed consultation with all parties affected.

Possible Difficulties or Objections

Politicians of different ideologies can dress up proposals in different ways, as either fitting into or going against their ideologies. I think this could reasonably be presented as a fair public-private partnership, building on the philosophy of the defunct South Western Alliance and a proper balance between the two. In fact it has been devised to be exactly that.

Others may however say the proposals are too complex. All re-organisation has its complexities, which will normally be necessary in order to cover everything and protect parties' interests where that is necessary. This re-organisation would actually be very simple in concept. It is, and can be presented as, not the abolition of Network Rail but the devolution of its functions in a way that re-unites train operation and infrastructure and makes the operation of the network more accountable, more able to be customer-focussed, more likely to perform and cost less, and more able to unite infrastructure and trains right down to the very lowest interface.

For the future, a requirement to become NewCo shareholders could be imposed on passenger rail operators in any future new franchises or extensions of existing franchises. The operators would either have to accept the benefits and responsibility in relation to NewCo or not bid or get a franchise extension at all. But current franchise holders could not be compelled if unwilling. They could only become shareholders if when the proposals were introduced they agreed and accepted the obligations of a shareholder and the (hopefully theoretical) risk of having to repair holes in NewCo's profit and loss account if they could not be repaired by any other means. Hopefully they would see the benefits to them of being involved in NewCo and the additional influence it would bring them; and not want to exclude themselves from the system and see other train operators participating in decisions about "their" lines.

Status of these proposals

At the moment these are just my personal thoughts. Although I am the Chair of Bolton Rail Users Group, the Group has not considered this subject or declared any policy or objectives in relation to Network Rail or the Shaw Report. The proposals arise solely out the invitation to me to participate in one of the regional working parties for the Report and past experience in the establishment of public-private partnerships and the use of companies for the purpose of delivering or planning public services on a single or multi-agency basis.

I don't necessarily present the proposals as the best, or only, way forward. Considerably more work would be needed on them before they were implemented and possibly some changes made. I nevertheless offer them in the hope that they may be of assistance – as a possible vehicle on which some or all of the substantive recommendations of the report will be able to ride.

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