ORR round-table discussion on financial sustainability in rail

14 January 2014

Chaired by Professor Dieter Helm.

This is a summary of a discussion hosted by the Office of Rail Regulation (ORR) on 14 January 2014, and chaired by Professor Dieter Helm, about issues of financial sustainability in the UK rail sector.

The purpose of this roundtable event was to stimulate debate between experts in the rail, finance and regulatory sectors about the future efficiency and sustainability of the investment and funding framework for rail. The discussion built on ORR's Long Term Regulatory Statement, published in July 2013, which discussed, among other things, the financial sustainability of the current investment and funding framework for rail.

Many of these issues have been highlighted by the recent announcement from the Office of National Statistics that Network Rail will be re-classified in September 2014 as a central government body in the public sector. Continued high levels of public financial support for the sector makes it important that the rail sector is increasingly financially transparent and accountable, and that it ensures that on-going levels of investment are sustainable over the long term.

The event was held under Chatham House rules, and this note summarises the key points that were discussed by the participants.

The first part of the round-table discussion focused on identifying lessons from other public and private infrastructure companies in transport and utility sectors about how regulation can best support the integrity of management independence while assuring strong accountability in a public sector environment.

- The challenge for rail is to ensure that the current funding model remains sustainable and affordable in light of the continued high level of investment that is anticipated to be needed to keep up with demand on the existing network, in addition to the need to fund significant additional new investments like HS2.
- Decision-makers in industry and government always need to be clear about what they are financing and what benefit they seek from it, where the revenue to support investment will come from, and the risk that is associated with it. This requires a better understanding of true costs and a better reflection of those costs in in the price of infrastructure services.
- This is particularly difficult in rail, because real costs and prices are obscured by government subsidy to Network Rail in the form of the Network Grant rather than to the users of the network, the TOCs.

- Regulatory incentives work gradually, as they cascade through industry management systems, so beware of precipitous change. If government role increases because of the re-classification of Network Rail then the point of level intervention is changed. The consequences could be unplanned for and undesirable.
- A stable and predictable regulatory regime can help insulate against politically motivated uncertainty, particularly when there is a change in government.
- Long-term funding and incentive frameworks mean that the industry can continue to focus on delivering more for customers. This stability also strengthens accountability as the industry cannot so easily request further funding if it fails to deliver agreed outputs.
- Not all incentives are, or have to be about, money. Successful career development, prospects beyond organisation, discretion to manage and make informed decisions are all strong incentives especially in the public sector.
- A powerful driver of incentives is the need for clarity of what they should achieve, the funding and how success is measured.

The discussion moved on to how the government's new role as ultimate shareholder of Network Rail could be most effectively balanced with its on-going role as customer and purchaser of subsidised rail services.

- It is important that conflicting objectives between legitimate government interests be avoided so that investment in the public interest continues while also maintaining a strong and efficient focus on customers.
- The Government needs to decide what it wants to finance and what benefit they seek from it. This means understanding better where the revenue to support investment will come from, and the true costs of subsidising services.
- Real costs need to be much better reflected in the price of infrastructure services so that normal price signals work to generate useful information for policy-makers about where public support could most effectively be applied.
- Wherever possible the industry should be left to do detailed planning, with the regulator benchmarking to see if outputs are stretching. This process has proved to be credible, and there are benefits to stability for planning and customers.
- The regulator potentially has an enhanced role to play working in between the government's shareholder function and the company as an independent management team.
- Regulators in other sectors are having more of an input into the decisions on the outputs/outcomes wanted which may not always join up with government. Certainty on the original funding model is needed to assess value for money.

The discussion drew to a conclusion by identifying some early questions for ORR's 2018 regulatory review, in which ORR will consider how regulation can support strong incentives on Network Rail to invest and operate efficiently as

customer-focused company, while providing assurance to government about the efficiency and sustainability of the services that it is funding.

- Important that any anxiety surrounding Network Rail's re-classification does not undermine the strong and effective incentives already applied by the regulatory framework. Both the High Level Outcomes Statement (HLOS) from government and the Regulated Asset Base (RAB) were valuable mechanisms which should be maintained.
- Re-classification actually puts the efficacy of regulation into sharper focus as well, and creates an opportunity to look back over the past five years and the lessons learnt about what works. Government should take the opportunity to re-state the case for independent economic regulation.
- The financial structure of the industry has an important effect on incentives for efficiency and performance.
- The industry needs to be able to finance its costs, raise new funding to support investment, and structure its finances in a way that creates and strengthens real incentives for efficiency.
- The rail industry is full of individual issues which are knitted together as a complex whole and a new approach ensure incentives are aligned across the sector particularly between Network Rail and franchises. This was more important than whether an entity was publically or privately owned.
- Going forward, clarity of objectives, funding envelopes, levels of subsidy and performance against objectives for specific activities were all very important: all of these could help reinforce a culture of continuous improvement
- Where competition is not possible or limited, proxies such as comparative information or requiring competitive tendering of specific activities could play a very valuable role.
- Looking at changes that need to be made to give the regulator power or responsibilities that it doesn't currently have, but regulators in other industries do.