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**Network Rail's Governance****Discussion Paper Prepared for the DfT and ORR****5 January 2011****1. Introduction**

This paper contains an independent and impartial perspective on the governance arrangements at Network Rail. The paper is structured into three main parts:

- section 2 identifies what we see as the features of good corporate governance;
- section 3 evaluates a number of possible ways in which Network Rail's governance arrangements might be changed and its accountability improved; and
- section 4 concludes with our thoughts on the sorts of changes that should be given further consideration.

**2. The Features of Good Corporate Governance****2.1 The UK model**

The subject of good corporate governance in companies generally is one that has attracted a great deal of attention in the UK over the last 20 years. By our count there have been at least six independent reviews of governance arrangements during this time, starting with the Cadbury Report in 1992 followed by the Greenbury Report (1995), the Hampel Report (1998), the Turnbull Report (1999), the Myners Report (2001) and the Higgs Report (2003).

All of this work has been built around a very clear perception of the respective roles of a company's owner and its board. The Cadbury Report expressed this relationship in the following terms:

Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and the shareholders in general meeting.

The model which Cadbury outlines in his report can best be described in terms of a principal-agent relationship. The principals – i.e. the owners – are interested in the successful long-term operation of the company. They delegate responsibility for achieving this objective to an agent – i.e. the board – whose job it is to decide how best to further the owner's ambitions. Crucially, the principals then allow the agent to get on with the job of running the company subject to a number of formal checks and balances. It is not for the principals to involve themselves in detailed planning or to interfere with day-to-day management decisions, other than in very exceptional circumstances.

The work carried out by Cadbury and those that followed him is today reflected in the UK Corporate Governance Code issued by the Financial Reporting Council, which all listed companies must adhere to under the FSA's Listing Rules. It provides an important starting point in any debate about governance because the model that we have just described has served the UK well over a period of many decades and is the model that the high quality management that

Network Rail should be attracting will be used to working within. It is primarily for this reason that Network Rail's licence requires it comply with the Code as if it were a listed company even though Network Rail has members rather than shareholders and is not a PLC.

The specific responsibilities that the Code identifies are described below.

## **2.2 The role of the board**

The Code states<sup>1</sup> that it is for a board to:

- provide entrepreneurial leadership of a company;
- set the company's value and standards;
- set the company's strategic aims;
- ensure that the necessary financial and human resources are in place for a company to meet its objectives;
- review management performance; and
- ensure that a company's obligations to its owners and others are met.

The Code also states that board should meet regularly, keep a formal schedule of matters reserved for its discretion, and should contain a sufficient balance of skills and experience as is appropriate for the requirements of the business. Through these arrangements the Code is clear that it is the board that is collectively responsible for the ultimate success of the company.

## **2.3 The role of the non-executive directors**

The Code recommends<sup>2</sup> that at least half of the board should be independent, non-executive directors. The Code states that the role of the non-executive director is to:

- constructively challenge and contribute to strategy;
- scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance;
- satisfy themselves that the financial information is accurate and that financial controls and systems of risk management are robust; and
- determine appropriate levels of remuneration for executive directors and have a prime role in appointing, and where necessary, removing senior management.

To help them carry out this role, the Code recommends that the non-executive directors should from time to time hold meetings without the executive present, that the majority of the members of the nomination committee and all of the members on the remuneration and audit committees should be non-executive directors, and that the non-executive directors should have access to independent professional advice where they judge it necessary to discharge their responsibilities as directors.

## **2.4 The role of the owner**

Given the extent of responsibilities that are taken on by the board and the directors, the formal role for the owner under the Code is relatively limited. The Code states that the company's owners, in the form of its shareholders, are ultimately responsible for:

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<sup>1</sup> Section A1.

<sup>2</sup> Section A4.

- the election and re-election of the company's directors;
- approving the appointment, reappointment and removal of the external auditor;
- approving the annual report and accounts; and
- voting on other matters that are brought to them by the board at an AGM or EGM.

In addition, the Code also places considerable weight on regular consultation between shareholders and the board, its Chairman and the non-executive directors so that the board understands the issues and concerns of the company's ultimate owner. Importantly, it is primarily through this informal engagement, rather than formal mechanisms, that the shareholders in a PLC structure influence a board.

### **3. Questions That Have Been Asked Of Network Rail's Governance**

The material that we have presented in section 2 provides useful context for anyone proposing reforms to the system of governance at Network Rail. Over the last 3-4 years we have heard a variety of criticisms of existing arrangements and a number of proposals for dealing with the identified problems, most of which build from the following ideas:

- the key issue is said to be a deficiency in the accountability of Network Rail's management, caused by the decision to hand ownership to 120 members of disparate backgrounds and no obvious standing in the railway;
- it is then argued that a lack of clarity of purpose on the part of these members translates into a lack of clarity of purpose for the company more generally, which makes it impossible for members to tell if the Network Rail board is doing a good job or to bring any real discipline to the company's decision making;
- Network Rail therefore needs a new guiding mind to set the company's objectives and hold individual directors to account for the way that they deliver against those objectives; and
- to ensure that these new persons are themselves doing a proper job, there may need to be some form of democratic accountability in which office holders are appointed or elected by stakeholder community at large.

We consider each of these points in detail below.

*Is there a lack of clarity as to the role of the Network Rail members?*

In a strict legal sense, the role of Network Rail's member is very clear. Under Network Rail's Articles of Association the members are responsible for:

- the receiving of the company's annual accounts;
- the appointment and reappointment of directors;
- the appointment and reappointment of the company's auditors; and
- approval of any changes to Network Rail's constitution

By and large this mirrors very closely the role that shareholders have in a conventional PLC structure and in the Combined Code.

When people say that the role of Network Rail's members is not clear what we think they mean is that it is not obvious what values the members should apply when exercising their rights to vote on all of the above matters. A lack of consensus amongst even the members themselves about

the purpose of their role was one of the key points to emerge from KPMG's 2008 review for Network Rail and has continued to hamper proposals from to change the composition and input given by the members.

In a normal company, the value system is very obvious: shareholders/owners invest in order to make money. Network Rail was deliberately set up in a way that departs from this convention – rather than see the company run to maximise profits, the government wanted to see Network Rail act in the interests of passengers, customers and funders alone. The existence of a profit motive was seen as a hindrance from this objective and the CLG structure was seen as a way of eliminating a distraction from management's decision making.

One could argue that this *raison d'être* has not been imprinted formally on Network Rail's membership and, as a consequence, some now complain that Network Rail itself lacks a clear purpose. We think that this is a little unfair; if one looks at Network Rail's licence and its contracts with train operator customers, its purpose is very clear. It is to:

operate, maintain, renew and enhance the network in a timely, efficient and economical manner so as to satisfy the reasonable requirements of customers and funders

(paragraph 1.1. of Condition 1 of Network Rail's licence)

Given the clarity with which this can be stated, we do not think that a critique of the Network Rail model should start with a concern that the company's objectives are ill-defined. It is, however, legitimate to ask how well this has been communicated to Network Rail's members and for this reason we can see merit in giving the membership some form of mission statement that draws directly on the above principles. For the avoidance of doubt, though, we do not think that it would be helpful for Network Rail's members or any other body to be given responsibility for determining the company's purpose. Network Rail's licence and its contracts leave no room for doubt as to why the company exists and any attempt to depart from this understanding can only lead to confusion and conflict.

*Should there be a new supervisory body to hold the Network Rail board to account?*

If there is clarity as to Network Rail's purpose the questions that are asked about governance become ones about whether the Network Rail members are capable of properly holding the Network Rail directors to account for their performance against the Condition 1 objective. In our contacts with industry stakeholders we have detected a growing view that the members lack the expertise and organisational capabilities to exert genuine discipline and that a smaller group of individuals would be better able to monitor and challenge the Network Rail management.

Before one can take a view on the reforms that this proposition would entail, we think that it is necessary to answer three key questions:

- should it be that overall control of Network Rail is divided between two distinct groups of individuals (i.e. the board and the trustees/super members/supervisory board that various stakeholders have suggested should replace the existing members);
- why would the trustees or super members be any more qualified than the Network Rail board to make important decisions and/or any more likely to act in the long-term interests of customers and funders; and
- how could one be certain that Network Rail would not be 'captured' by individuals acting in the interests of one particular group of stakeholders?

The proponents of change would have it that a two-tier management structure would produce better outcomes than the existing unitary board. In particular, the trustees/super members/supervisory board would reflect the interests of passengers, customers and funders and thereby implant in Network Rail a focus that the company currently attains only indirectly via the obligations in the company's network licence and ORR's regulatory interventions.

There are, however, other possibilities that ought to give stakeholders pause for thought. One is that the trustees/super members – especially if they are to be elected – turn out to be no more than concerned citizens, eager to play their part in the running of the railway. If this is the case, one would have to ask what qualifies these people to be guiding Network Rail's strategy. In this regard, it is worth noting that Network Rail already involves outsiders directly in its running through the appointment of non-executive directors. At first sight, the creation of a trust structure might appear to replicate the role that the non-executives play on a day-to-day basis suggesting that little value would be added (we return to this theme below).

Another, potentially more worrying possibility is that the trustees/super members/supervisory board might come to represent a relatively narrow group of railway stakeholders. In this scenario it is possible that Network Rail would be captured by a specific interest group, who would make use of their role as 'insiders' to benefit themselves at the expense of 'outsiders'. This would unarguably be a step back from the current position.

In the absence of any certainty about from where exactly the required individuals would be drawn, the inherent unpredictability that we have identified is a significant weakness of most of the trustee/super member/supervisory board propositions. It is perhaps worth remembering at this point that the Network Rail membership arrangements were deliberately designed to prevent members from organising themselves into factions that could come to take control of the company. To now pass ownership – and the rights that go with ownership – to an unknown and unknowable group of individuals would, in our view, present a considerable risk.

We are, in any case, far from convinced that the 'problem' with the Network Rail model has been shown to lie in a lack of activism among its members. There is a particular question mark in our mind about the wisdom of creating a two-tier structure in which full-time Network Rail directors must – as a matter of course – take direction from a part-time supervisory board. One would think that rather than disempower the existing board it is better for those working inside the company to take the lead in areas like strategy formulation and to be held to account for their choices. Moreover, if one compares the responsibilities that it has sometimes been suggested that the trustees/super members might take on – i.e. strategy formulation, hiring and firing, the setting of remuneration – with the bullets in section 2.3 it is apparent that there is a very big overlap with the role that is currently fulfilled by the Network Rail non-executive directors. It is to this aspect of governance that we now turn.

*Are the non-executive directors doing the job they are supposed to do?*

As we explained in section 2.3, a typical UK company relies upon the non-executive directors to hold the executive directors to account. Network Rail currently has a large number of non-executive directors who ought to be capable of bringing a wealth of skills and experiences to the running of the company. The real question about Network Rail's governance in our mind is: are those skills and experiences being used in the way that the Combined Code recommends?

As outsiders it is impossible for us to answer this question, and one might argue that it is precisely this lack of transparency is causing certain observers to interpret wrongly the degree to

which Network Rail's management are being challenged and held to account. We think it would be to the benefit of the industry for the role of Network Rail's executive directors to be made clearer. In particular, we think that Network Rail might seek to be more open about:

- the formal responsibilities that the non-executive directors have within the company;
- the ways in which the non-executive directors obtain the information that they require from the business in order to discharge these responsibilities;
- the input that the non-executive directors have given and are giving into strategy and other key policy decisions; and
- the extent to which the non-executive directors have drawn on independent professional advice to help them fulfill their role.

It is possible to think all number of different ways in which such transparency would help to assure the industry that the non-executive directors are playing an active role in protecting the long-term interests of the railway. Consider the following examples:

- the company is currently having to grapple with major strategic issues as it addresses the challenges of delivering HLOS and ORR's periodic review determination. Insofar as this requires organisational and/or structural change, the non-executive directors ought to have been helping to shape the company's strategy from an early stage. If the process for providing this input were more transparent, or, better still, if the views that the non-executive directors are giving were to be made public, it would help to reassure the industry that Network Rail is facing up to the hard choices that it faces in meeting its CP4 obligations.
- as a second example, one very important issue that the company currently faces is the need to improve its record in delivering major projects. According to the Combined Code, the non-executive directors ought to be investigating the causes of the company's difficulties in this area and assuring themselves that the remedial action taken by management is sufficient to address the problems identified. Unfortunately, outsiders cannot currently be sure that this is happening and are unable to draw attention to the deficiencies in Network Rail's governance if it is not. Transparency from Network Rail on the role that the non-executive directors have in this sort of situation, followed in due course by details of the actions that they have taken in specific cases, would therefore be of real benefit to the industry; and
- finally, Network Rail has in recent months been promoting the idea that it should convert itself to a shareholder-owned company. A change of this importance ought to have been assessed and approved by the non-executive directors well before it was put to external shareholders. It is not clear to many in the industry whether this has been the case, what views the non-executives have and how far they support the company's lobbying of government.

The key point which arises from this discussion is that there are already individuals who are in exactly the right place to perform the role that some have suggested might be given to trustees, super members or a supervisory board. There is also already a Code that sets out very clearly the responsibilities that the non-executive directors are to discharge. If the industry had a better understanding and visibility of the accountability that this creates, it may well be that calls for a new tier of supervision fall away. This might mean that:

- Network Rail publishes the minutes of its board meetings;
- the non-executive directors meet separately at least once every quarter and publish minutes of their meetings; and/or
- the Chairman meets regularly with stakeholders and speaks more publicly about the role the non-executives are playing.

Others may also have other ideas about how the work of the non-executive directors can be made more transparent.

*Should certain railway stakeholders have a right to appoint non-executive directors to the board?*

The one possible flaw in a model that has the non-executive directors of a CLG take the lead in holding management to account is the possibility that the executive directors will use their influence and the relative weakness of the membership to create a board of supine or subservient non-executive directors. We are reluctant to say that this has been the case to date, although we have encountered others in the industry who take a different view. It may nonetheless be worthwhile thinking through at this time the process by which non-executive directors get appointed in future.

The current system sees existing directors select new board members and put those individuals to the Network Rail members for approval at the AGM. This is identical to the process in conventional PLCs (and it is worth noting that it is extremely rare to see the board's recommendations voted down in such companies). An alternative model would give the persons identified in Condition 1 of Network Rail's licence and affected most directly by Network Rail's actions – i.e. customers and funders – the role of nominating some or all of the non-executive directors. As a very indicative straw man, one director each could perhaps be nominated by: the DfT; Transport Scotland; ATOC; freight operators; and Passenger Focus, each of whom we see as having a legitimate and, Transport Scotland aside, roughly equal interest in Network Rail's performance.

Once appointed, these directors would not and could not act as representatives of the nominating organisation. (The Companies Act imposes on directors obligations to act in the best interests of the company and to exercise their powers only for a proper purpose.) As in the case of any other non-executive director, they would simply monitor and challenge the company's record in operating, maintaining, renewing and enhancing the network in a timely, efficient and economical manner so as to satisfy the reasonable requirements of customers and funders.

The safeguard for customers and funders is that they would be choosing the people carrying out this role. They can be expected to choose individuals with the right level of skills and experience and with sufficient presence to hold their own in the Network Rail boardroom (and if they do not they can have little cause for complaint about the quality of Network Rail's management). Moreover, the very process of being interviewed and nominated by a customer or funder prior to appointment ought to instill a sense of wider duty that may not be present under existing arrangements.

ORR and the DfT would need to seek legal advice on the mechanics of making this change. Our instinct is that a relative simple change to Network Rail's Constitution may be all that is required in order to give specified stakeholders the right to nominate directors, leaving the remainder of the Network Rail structure largely intact and averting any need for a potentially divisive change in Network Rail's ownership. (NB: the Department for Transport already has a right to appoint a



director, but has chosen not to exercise this right.) The DfT will also need to understand any implications for the classification of the company in the public accounts.

*Might it be that concerns about Network Rail more to do with the problem of monopoly than governance?*

Irrespective of any action that is taken in this area, we would also encourage people to think carefully about whether the debate about the Network Rail model should be about governance arrangements or whether it should focus more on the underlying problem of monopoly. Whilst Network Rail has an unusual ownership structure, it also differs from a conventional PLC in that:

- the company does not face the threat of competition and its customers cannot turn to alternative suppliers in the event that they are dissatisfied with Network Rail's performance;
- the company's debt is guaranteed by the government and there are no financial consequences if the business is unable to live within its budgets; and
- customers and funders must therefore rely upon ORR to discipline Network Rail's behaviours and align the interests of the company with the interests of its stakeholders.

Any critique of Network Rail's corporate structure has to deal with all of the factors highlighted above. A weakness arising from inadequate corporate governance, for example, cannot sensibly be analysed without reference to the fact that customers have no choice but to contract with the company. Similarly, questions about what drives management in the absence of a conventional owner can be answered (at least in part) without looking at the lack of a hard budget constraint.

It follows that any debate about perceived weaknesses of the Network Rail model has to include a discussion about how best to reduce the reach of Network Rail's monopoly – e.g. by passing responsibilities on to other parties like train operators – and/or expose the company to competitive pressures. We have argued elsewhere that the two most promising avenues to pursue are:

- contestability – i.e. exploring ways in which Network Rail's stranglehold over railway expenditure could be broken via the opening up of new projects and/or the operation, maintenance and renewal of stand-alone assets like stations to competition; and
- horizontal separation – i.e. the possibility that Network Rail could be split into regional businesses.

In the medium to long term, developments in either of these areas could have a major impact on Network Rail's responsiveness to customers. In our view even a small amount of competition (whether real or comparative in nature) would help to ensure that Network Rail's managers make the right decisions from the outset, rather than relying on good corporate governance to correct mistakes as they occur.

#### **4. Conclusions**

Our intention in writing this paper has been that the preceding discussion will encourage interested parties to think about Network Rail's accountability in terms that go wider than the ongoing debate about the role of Network Rail's members. Having considered ideas revolving around a new tier of supervision in some detail, we would suggest that proposals for a trust and/or super members and/or a supervisory board are the wrong solutions for a problem that has yet to be properly articulated. Instead, we think that the preceding discussion shows that

concerns about governance are best addressed in the short term by looking in detail at the role of Network Rail's non-executive directors.

To progress this further, ORR and the DfT might wish to consider commissioning an independent review of Network Rail's corporate governance. This might look like and build on the Higgs, Myners, Turnbull, etc. and look much wider than the KPMG report on the membership aspects of governance.

Without the benefit of this expert review, our sense is that the industry would benefit most from:

- Network Rail giving its members a mission statement built from the obligations in Condition 1 of its licence;
- the non-executive directors being much more transparent about the ways in which they are holding Network Rail's management to account. This might mean that board minutes are published, that the non-executive directors meet separately once a quarter and publish minutes of these meetings, and/or that the Chairman speaks regularly and publicly about the role of the non-executive directors; and
- giving consideration to the possibility that some or all non-executive directors are nominated by customers and funders.

In the longer term we think that the best solution to weak governance is choice for customers. When one compares Network Rail's governance arrangements with the provisions of the UK Corporate Governance Code, it is difficult to conclude that the Network Rail model is inherently deficient. The main difference between Network Rail and a conventional company lies instead in its monopoly position and the scope that this creates for under-achievement. In our view, it is this problem which should occupy policymakers' attention.

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