Network Rail - Making a Fresh Start

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL
HC 532 Session 2003-2004: 14 May 2004

Ordered by the
House of Commons
to be printed on 10 May 2004

LONDON: The Stationery Office
£9.25

Summary

1 Network Rail owns and maintains the national rail network, which mainly comprises tracks, bridges, stations and signals. The structure of the rail industry and the relationships between Network Rail and the other parties in it are shown in **Figure 1**.

Network Rail acquired Railtrack, which went into administration in 2001

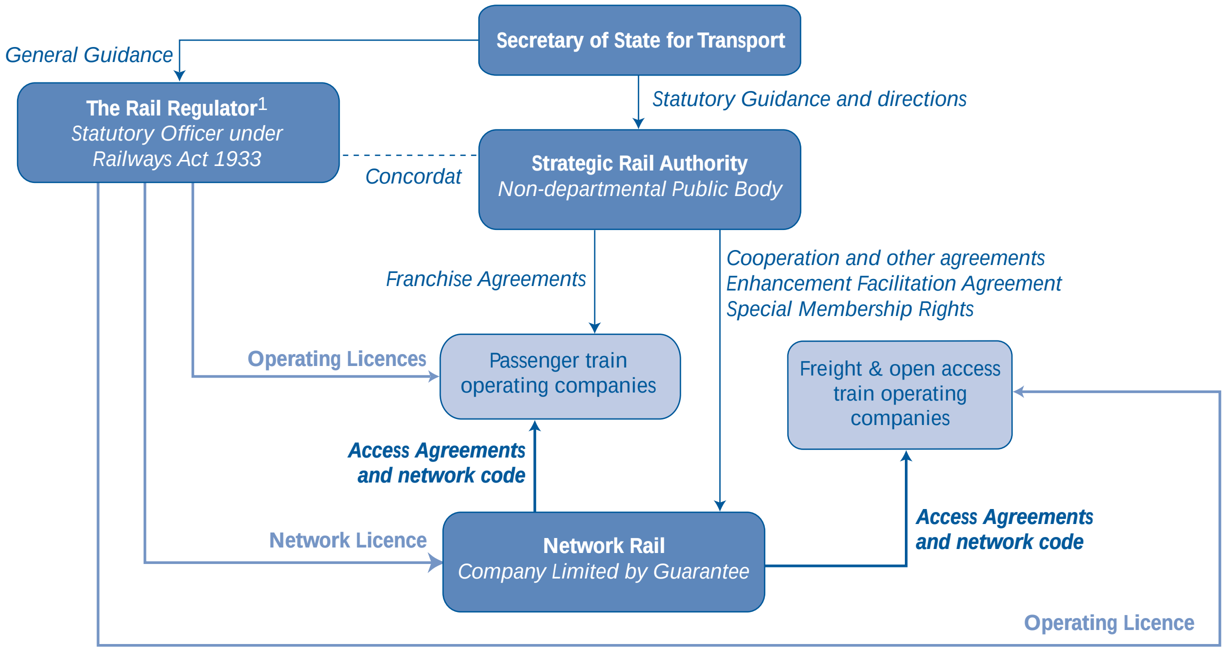
2 The owner of the national rail network from privatisation in 1996 was Railtrack, which had been created as part of the restructuring of British Rail. Railtrack was placed in railway administration on 7 October 2001 after which date Railtrack's business was conducted by administrators (see glossary) appointed by the High Court. A number of factors contributed to Railtrack's failure including lack of attention to its core business leading to underinvestment in the infrastructure, loss of engineering skills and poor asset knowledge.

3 Network Rail was established by the Department for Transport (the Department) with support from the SRA in March 2002 to secure the submission of at least one viable bid for Railtrack that would address the network's problems. Network Rail is a Company Limited by Guarantee, which means that it does not have shareholders, it pays no dividends and it finances its activities by retained surpluses and borrowing. Instead of shareholders, it has 114 members representing different interest groups. Network Rail's bid for Railtrack was the only one received. It took over the business in October 2002.

4 As Network Rail's income was not sufficient for it to meet its expenditure plans and develop into a self standing business, the Rail Regulator (the Regulator) undertook an Interim Track Access Charges Review. The review was completed in December 2003 and the conclusions, which came into force in April 2004, determined the following:

- the infrastructure expenditure permitted for the five years to 2009 (£22,200 million excluding enhancements to the network) and the income Network Rail will need to cover such spending;
- the outputs Network Rail must deliver (particularly in terms of cutting delays and improving asset condition); and
- the range of performance incentives that will apply, taking into account Network Rail's status as a company limited by guarantee.

1 The structure of the Rail Industry



NOTE

1 The Rail Regulator is legally independent of the Secretary of State, approves access agreements and supervises the terms of the network code (see glossary).

2 Her Majesty's Rail Inspectorate & The Rail Safety and Standards Board are not shown on the diagram (see glossary).

Source: National Audit Office

5 Despite the establishment of Network Rail and other changes to the industry since Railtrack went into administration, the Department was not satisfied with the performance of the rail industry. In January 2004 it announced a review, to be concluded by summer 2004, of:

- the structure and organisational changes needed to improve performance for customers;
- the progress being made by increased investment in the industry and the means by which costs can be better controlled; and
- the right organisation to focus safety regulation on the real risks to passengers and employees without being an obstacle to providing reliable train services.

The Department made it clear that its review would not call into question the independent economic regulation of the industry.

Would changes to Network Rail's governance and financing framework improve the management of the rail network?

6 This report examines Network Rail's governance and financing framework and whether changes would incentivise improved management of the network. It finds a number of challenges still outstanding:

i The establishment of a framework to incentivise value for money was handicapped by lack of information on asset condition and the drivers of costs. The incentives to achieve value for money, as opposed to staying within budgetary targets, depend to a large extent on the effectiveness of the corporate and management incentive arrangements. Management will also be concerned to avoid reputational damage (for example from the business being seen to fail) and the impact of this will be compounded by the transparency with which industry progress is reported. Although the incentive arrangements are overseen by the Regulator, it is notoriously difficult to get such management incentive plans right. Given Network Rail's key role in the industry the relevant parties should address whether the existing incentives could usefully be complemented by longer term financial objectives.

ii Rail industry costs are coming under control although expenditure is forecast to remain 30 per cent higher than before the 2000 Hatfield derailment by the end of the current regulatory settlement in 2008/09. There are a number of reasons for expenditure remaining higher than before the Hatfield incident. These include inadequate investment in the core business by Railtrack, a "bow wave" of expenditure over the next few years as a high proportion of assets come to the end of their useful life and higher spending to address safety concerns. Network Rail has undertaken a number of initiatives aimed at improving business planning to prioritise work that will provide long term benefits and control the unit costs of such work. Progress cannot be achieved by Network Rail's actions alone. The review needs to identify how the totality of the rail industry can best work together and facilitate the objective to push overall rail costs down.

iii Network Rail's governance structure is complex. It is clearly accountable to many parties, including customers, members and the Regulator. Its accountability to the SRA has been an issue given the desire for it to be classified as a private sector business, the necessity of SRA support for its funding programme and the SRA's assumption of the equity risk of the business until Network Rail's financing is put on a long term, self standing basis. In particular:

a Members of Network Rail cannot fully replicate the role of shareholders. All of Network Rail's equity risk falls ultimately on the SRA. An issue is how the SRA can manage this risk effectively, with the Regulator, given the few direct levers it has.

b Network Rail cannot yet borrow on its own. Its short and medium term funding is supported by the SRA at a higher cost than pure government funding. The regulatory settlement has provided revenue certainty for the period 2004-2009 and the SRA takes comfort from regulatory responsibilities toward Network Rail's financial viability. SRA support, however, remains fundamental to Network Rail's long term debt finance. Although there is no current threat, there is nevertheless an issue as to how effectively the SRA can manage its exposure to the credit risk it monitors.

c There is an issue as to how the SRA can effectively provide the industry with a strategic lead. The Regulator has to act in a way he considers best calculated to achieve a broad range of duties, one of which is facilitating the furtherance by the SRA of its strategies when this duty is not in conflict with others (see glossary). The SRA can also contract with Network Rail for new projects to enhance the network. In other circumstances the SRA is wholly reliant on Network Rail's own commitment to the strategic objectives.

Recommendations and

While careful thought went into setting up Network Rail, and it must live within its borrowing limits and meet the requirements set by the Regulator, there are risks that remain and constitute challenges for Network Rail and for related parties.

Incentives and drivers of value for money

1 Incentives exist in the regulatory regime to promote better performance, to minimise the disruption caused by work on the track, to promote long term asset stewardship and to encourage overall financial efficiencies. The incentives to achieve value for money, that is to do more than stay within budgets (even though the budgets have been set to encourage efficiency) depend to a large extent on the effectiveness of the corporate incentives and the internally developed Management Incentive Plan. Reputational issues and the transparency of the industry performance will also play a part. It is notoriously difficult to get such Management Incentive Plans right. Profiled expenditure changes may already have made one element of Network Rail's 2003/04 targets appear less challenging than expected when set (para 2.33). Network Rail is improving its business planning to prioritise and control the unit costs of work that will provide long term benefits. Network Rail's management should go further and develop longer term output based efficiency and financial measures, such as bringing down the network cost per kilometre per passenger carried. These should complement, not replace, existing indices that promote better performance and long term asset stewardship. Network Rail should commit to a timetable for developing indicators that demonstrate whether or not it is meeting such objectives.

Costs of a network that is fit for purpose

2 There are complex cost-related issues:

a Adopting the right standards is essential to achieve cost effective safety related spending. Network Rail is increasingly adopting a more risk based approach to standard setting within its direct control. It should set an end date for concluding this process.

b The transition to a more risk based approach needs to be reinforced by supportive behaviour from all levels of management. This can be tackled through information and training, assisted by other parties whose actions can have an impact, and reinforced by monitoring levels of managerial competency.

challenges

Skilled personnel

3 The privatisation of maintenance and renewals work, through the establishment and sale of infrastructure companies, resulted in many former British Rail engineers being lost to the private sector related industries. This affects the important area of project management, where containment of costs for Network Rail's ongoing investment in network renewal depends on such specific expertise. Among other measures, current shortages in Network Rail could be redressed by promoting flexible secondment schemes between other businesses and Network Rail, which would benefit both parties.

Network Rail's governance and financial framework

4 The Regulator has a duty to facilitate the strategic network goals he considers best calculated to achieve a broad range of duties, one of which is facilitating the furtherance by the SRA of its strategies when possible. The SRA can also contract with Network Rail for new projects to enhance the network. In other circumstances the SRA is wholly reliant on Network Rail's own commitment to the strategic objectives. We therefore see difficulties for the SRA carrying out its strategic role within the industry. The Department should consider ways in which Network Rail, as a regulated monopoly, is to be given a strategic lead.

5 The SRA has formal powers to require a remedial plan after a significant financial failure has occurred leading to a drawdown of SRA standby facilities. The SRA monitors the projected use of standby loan facilities on a quarterly basis. Like any guarantor or lender, the SRA should require and act upon information on Network Rail's proposed course of action if projections of debt indicate a risk of future financial failure, recognising that Network Rail's proposed response would have to include seeking necessary consents from the Regulator and other bodies when applicable. The SRA have arrangements in place to enable them to do this. The Department should periodically examine the SRA's arrangements for managing the risks effectively.

6 The Regulator proposed a ceiling to Network Rail's borrowing which Network Rail has accepted although at 5 May 2004 the relevant licence modification had not taken effect. There should be limits to Network Rail's borrowing (expected to decline from a peak of 80 per cent of the Regulatory Asset Base in April 2004) so that imprudent borrowing is discouraged. It is possible that in the future there could be pressures to keep debt high, without repaying borrowing, in order to fund more work without increasing track access charges. Nevertheless, a prudent Network Rail should be put in a position to repay funds borrowed for investment over the useful life of the assets acquired in this way.

7 Network Rail is following a prudent and realistic accounting treatment of operation, maintenance and renewal expenditure. Operating and day to day maintenance expenses are expensed when incurred and renewals depreciated over the renewal cycle. Care should be taken to ensure a continuation of the current accounting treatment that prevents “patch and mend” spending being added to the Regulatory Asset Base as though it was renewals, as additions of this sort could lead to unrealistic increases in asset valuations and inappropriate debt funding.

8 The Department needs to bear in mind the relationship between the cost of Network Rail's debt and the extent of the SRA's credit support. If conditions in the financial markets change, the Department should assure itself that any wider benefits of indirectly supported borrowing by Network Rail can still be shown to outweigh the potential cost savings from Government directly supporting such debt, recognising that it might need to take legal powers to do this.