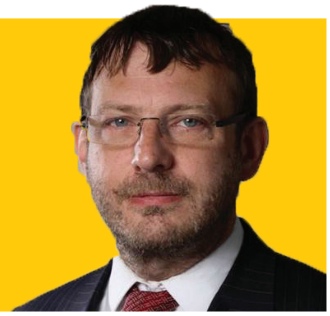
DAVID LEEDER



Can we defuse the Doomsday Machine?

Nicola Shaw's report on the future of Network Rail shows signs of getting past 'Must Try Harder' and addressing the difficult issues

In 2011, the McNulty Review was published to broad acceptance, whilst conspicuously avoiding the cost incentive issues that would have been obvious in any other industry. Such easy acclaim should have been a warning sign, and four years on, railway costs have grown to the point where Network Rail is now being micro-managed by Department for Transport appointees. Inevitably a new series of reviews is underway and Nicola Shaw's Part 1 review has now been published, and certainly contains far more intellectual fibre than McNulty.

In retrospect it was obvious that crucial reforms that one would have expected McNulty to address had been diluted or evaded, even before publication. But the industry then got to work, deploying the tried and tested strategies of producer interests everywhere - watering down proposals, delaying reforms and promising efficiency miracles in the distant future. Inevitably for a DfT publication, Shaw is polite on this point - couching her criticisms in technocratic jargon and emphasising overall rail industry growth. This author has no such constraints.

So who really killed McNulty's plans for efficiencies? As in Agatha Christie's famous railway novel, *Murder on the Orient Express*, all of the suspects appear to be guilty, because all of the economic actors benefit strongly from the status quo.

The TOC-owners in general have neither the balance sheets nor the project management experience to countenance significant investment in infrastructure. The ROSCOs have quietly benefitted from the structural shortage of rolling stock created by rapid demand growth, and their private-equity owners at the time of McNulty were much more focused on cashing out than taking part in risky infrastructure plays. Importantly the industry's executives and frontline staff continue to benefit significantly from the current arrangements.

Most importantly, Network Rail remains structured as the economic equivalent to the Doomsday Machine in *Dr Strangelove* - the fiendish nuclear device that, once activated, cannot be controlled and cannot be neutralised.

The twin problems that Shaw highlights very clearly are the extraordinary structural complexity of Network Rail, and the astonishing demand for government cash that an on-balance sheet Network Rail now represents. These problems can only get worse, given the political demand for more rail capacity, the implications of political devolution of transport policy within the UK, and the bombardment of EU regulation already affecting the sector.

Shaw clearly summarises the complex math and regulatory cat's cradle of Network Rail, and the reform options are logically set out.

> "All of the economic actors benefit strongly from the status quo"

However the political and cultural problems remain complex. How did we get here ?

Railtrack plc as created by the Major government was already a strange hybrid - a private monopoly that depended on subsidised customers for its revenues, and which was politically unloved even by a "Blairite" Labour Party that had been campaigning for rail nationalisation since before the First World War. Crucially, the Tories' model of Railtrack earned its income from track access fees and commercial income, such as property development. It was not intended to receive direct government grant. Indeed, it was expected at the time of its creation that an increasing proportion of total train mileage would be provided by open access operators, or unsubsidised franchisees. Therefore Railtrack may have taken on a more normal commercial character over time, perhaps comparable to that between the regulated airports owned by the privatised BAA plc and commercial airlines. But this was not to be.

The incoming Labour government's first decision was to politicise Railtrack's regulators, creating not one, but two hostile bureaucracies in the Tom Winsor-era Office of the Rail Regulator and the expansionist Strategic Rail Authority, who then proceeded to fight a three-way battle between Railtrack and each other.

Labour next introduced direct grants to Railtrack. This was a fundamental change, as much for its political impact as its economic one. In practice, the company probably had little choice but to accept the King's Shilling (the monarch in this case being John Prescott MP), but from this moment the company was probably doomed as a private entity.

The sequence of fatal derailments and collisions that followed in the early 2000s escalated the war of words still further, until the combination of political and regulatory hostility was simply unsustainable. Railtrack plc became a ward of the state and was replaced by Network Rail.

At this point in the evolution of the Blair government, the idea of a "Company Limited by Guarantee" (CLG) seemed to be an answer to a much broader question about how a post-Marxist Labour party would rethink how public utilities could be structured. A CLG would be simultaneously public and private, and would be "off-balance sheet" for HM Treasury. And

"A Regulated Asset Base with deficit financing, is like a bank without a locked safe"

there would be no vulgar shareholders, grasping for dividend, which solved a political problem and seemed to solve a financial one. Like most apparently new ideas, it was actually a very old one - a revival of the 1930s concept of a 'company owned by no one and accountable to everyone' that had led to the creation of both the BBC and the London Passenger Transport Board, as the first iteration of TfL, in 1933.

No doubt had Network Rail been a more immediate success, many other privatised utilities would have suffered the same fate as Railtrack. As it was, the financial problems of Network Rail were evident from an early stage, even to those ideologically disposed towards corporatist solutions. In 2003 the smart question was "who owns Network Rail?". It took just over 10 years before the question received a simple answer - Her Majesty's Government. By 2015 the fiction that Network Rail was in any way independent of government was no longer sustainable.

All of this recent history will impact the options for Network Rail reform in the future, and the positioning of industry participants, national (and increasingly regional) politicians, and potential investors.

What we have now is therefore the product of both a century of political hostility to private investment in railways, combined with a series of short-term structural expedients since 1996.

If the cleverest people in Britain had been specifically charged with the task of designing a machine to waste money, it is just possible that they would have come up with the current incentive structure. Network Rail's tortuous history has left it with a combination of economic incentives, all of which exist in other organisations, but which have rarely been combined to such damaging effect.

Any serious attempt at improving cost efficiency will have to move beyond producing another well-written headmaster's report on the theme of "Why You Must Try Harder" and Shaw's emphasis on financing contains encouraging signs that the economic problems are at last being pushed back onto the agenda. The DfT will need to work hard to confront the powerful vested interests that will resist change.

The starting point must be a recognition that no fundamental reform is possible without tackling the very flawed economic incentives currently in place. I will summarise just six (but there are others):

Network Rail August Bank Holiday works

1. Network Rail's customers are indifferent to price

The track access charging regime agreed in 1996, and only incrementally modified since, leaves the TOCs largely indifferent to the level of track access fees. If costs increase, subsidies go up (or premia go down), and vice versa.

This has encouraged a sense that track access costs are "fixed", whereas the 120 preceding years of railway history have shown that operational as well as infrastructure changes have a direct impact on operating costs. This suits the TOC owners, and leaves DfT and ORR advocating efficiency - a far weaker pressure than would exist if the TOCs' commercial lives were on the line.

2. Network Rail has a RAB

A Regulated Asset Base is a common device in privatised monopolies. A RAB is intended to allow transparent agreement about what assets the entity requires, and what they cost to build and maintain. It also acts as a direct incentive towards capital investment, because the higher the RAB, the higher the allowable profits that will derive from the regulated "X percent" profit margin set by the regulator.

Any utility with a RAB (eg the water companies, or the larger airports) will spend a great deal of time "talking up the RAB" - ie. trying to persuade a skeptical regulator that they really need that Richard Rogers-designed terminal, and not an off-the-peg shed of the kind that works perfectly well for Tesco (or an unregulated airport like East Midlands).

But they also have greedy private investors who have a strong incentive to beat the agreed plan, and take the savings as profit in the relevant regulatory control period. A RAB with deficit financing, is like a bank without a locked safe.

The importance of the RAB to Network Rail's future financing (and ownership) is now clearly back on the agenda and is well covered by the Shaw Report.

3. Network Rail is deficit financed

The difficulty with the current world of Control Periods, RABs and unpaused capex is that it conceals a simple truth - Network Rail is being deficit financed. Imagine the bank with the doors wide open and a sign saying "out to lunch - back in five minutes". We have returned to a situation where the difference in practice between Network Rail's actual spend and its income is the subsidy - the kind of 'deficit funding' used to prop up British Leyland in the 1970s. And performance fines become useless - the government, in effect, fining itself.

This must be the central driver of the current Treasury anxiety regarding Network Rail's cash needs.

4. Network Rail has no private shareholders

To believe in Network Rail, you really have to believe that a government department is better at managing costs than someone like Sir Brian Souter whose personal wealth is at stake. Since the 1960s, very few people have justified state ownership on the basis that it will lead to lower costs.

Figure 17 from Shaw's report adeptly summarises the real world options facing the DfT. The political problem is that most of these options can be represented as a return to privatisation. Many of them are. Political opposition will bring with it a financial price, in terms of higher cost of capital and lower asset valuations. This is a topic that I will return to in a subsequent article.

> **"The political problem is that most of these options can be represented as a return to privatisation"**

5. Network Rail can't be easily benchmarked

There's only one Network Rail. And although other track authorities do exist in the UK (Shaw's own HS1, the London Underground, Northern Ireland Railways, the urban subways and light rail schemes) all of them are to some extent special cases, and none seem keen to fall under the economic wing of what was the ORR.

This makes benchmarking extremely difficult. Without real-world comparators, cost benchmarking - intrinsically complicated - becomes an interesting academic exercise that Network Rail is almost guaranteed to win.

6. Network Rail is 'too big to fail'

Railtrack conclusively proved that a single-network operator was "too big too fail". But it may also have shown that such a large entity was too large to be investible. As Shaw points out, many investors around the world are seeking infrastructure opportunities, but Network Rail as a unified entity is both too large and too politically risky to access this kind of capital.

Any break up of Network Rail (and Shaw presents multiple options, albeit in outline only at this stage) will need to address "Size & Shape". Put simply, the pieces that may be detached will have to be coherent in operational, market, political and financing terms. This is no trivial problem. Given the current political orientation of the Corbynite Labour Party (and the history of the railways under Blair), the political problem of building a consensus for reform remains immense.

The current reviews do not need to solve all of these problems simultaneously, but failure to tackle the fundamental economic factors is unlikely to deliver significant medium-term improvements. A reform package that does not provoke opposition from the beneficiaries of the current structures is probably too cautious to deliver the major change that is needed. Shaw's initial report contains encouraging signs that we are moving beyond "Must Try Harder". ■

NEXT TIME: PROPOSALS FOR REFORM

FIGURE 17: SPECTRUM OF POTENTIAL FUNDING AND FINANCING OPTIONS

Source: The Shaw Report: The future shape and financing of Network Rail The Scope (November 2015)

Introduction of private capital ←→

		Full	Partial	None
Parent company	EQUITY	Full privatisation	Partial privatisation	Full Nationalisation
	DEBT	Unsupported debt	Government guaranteed debt	Existing market debt fully repaid
Parts of the company		Sale of assets/route(s)	Concessions/ other contractual arrangements	Part funding from other local/devolved governments
Specific projects		Privately owned special purpose vehicles	Private and public partnerships; other contractual arrangements	Loans/grants/ levies from any public sector bodies

ABOUT THE AUTHOR

David Leeder has over 20 years of experience in transport, and was an executive director of National Express Group and a main board director of FirstGroup. He is co-founder and CEO of the German bus business MET and managing partner at Transport Investment Limited.

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