

OCCASIONAL LECTURE 10

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THE STUDY OF
REGULATED
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**THE FUTURE OF THE RAILWAY
INDUSTRY THROUGH EFFECTIVE
INDEPENDENT REGULATION**

Tom Winsor



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THE FUTURE OF THE RAILWAY INDUSTRY THROUGH EFFECTIVE INDEPENDENT REGULATION

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PREFACE

The CRI is pleased to publish **The Future of the Railway Industry Through Effective Independent Regulation** as Occasional Lecture 10. The lecture was given by Tom Winsor, the Rail Regulator, on 21st January 2004 at University College London.

Tom Winsor makes his case for independent rail regulation robustly, and makes it clear that the Government supports, and has consistently supported, that position. We can only look forward to the outcome of the Government's current review of the rail industry, due to report in the summer of this year.

His comparisons with the other regulated utilities and network industries are also of particular interest, suggesting that their common foundation of independent economic regulation is not undermined by the fact that rail, uniquely among them, receives large Government subsidies. In fact, he argues that it simply emphasises the fact that the Government (or its agency, the SRA) has to be clear about the outputs it expects to be delivered by the industry, so that the Rail Regulator, through periodic access price reviews, can determine the allowed revenue necessary for an efficient and effective company to deliver those outputs.

A clear conclusion of his analysis is that if the Government does not like the consequent level of subsidy, then it has to take responsibility for changing the level of outputs it expects. This is an 'iterative' planning model which has been well developed in practice in the water sector through the 'quadrupartite' process, a process linking Defra, the Environment Agency, Ofwat and the regulated companies in a business planning cycle which reconciles final output requirements to affordability.

Peter Vass,
Director (CRI)
February 2004

Tom Winsor - The Rail Regulator

Tom Winsor (46) was born, brought up and educated in Broughty Ferry, Dundee. He studied law at Edinburgh University and, after a few years in general legal practice in Dundee, undertook a Diploma in Petroleum Law at the University of Dundee. In 1984, after a brief period in practice in Edinburgh, he moved to Norton Rose, London. In 1991 he became a partner at the international City law firm Denton Hall.

From 1993-95, Mr Winsor was seconded from Denton Hall to be Chief Legal Adviser and General Counsel to the first Rail Regulator, John Swift QC, in the period when rail privatisation was being designed. In 1995 he returned to Denton Hall to head the firm's railway law department.

In July 1999 Tom Winsor resigned his partnership at Denton Hall on his appointment as Rail Regulator. His five-year term of office lasts until July 2004.

THE FUTURE OF THE RAILWAY INDUSTRY THROUGH EFFECTIVE INDEPENDENT REGULATION

Tom Winsor

Introduction

This lecture is about the future of the railway industry through effective independent regulation.

To begin with, by way of overview, the first question appears to me to be this: does the railway have a future? I think the answer is yes. It is essential to the economic, social and environmental wellbeing of regional and national economies. That much is quite clear from the Secretary of State's statement which he made a couple of days ago in relation to a review of the railway industry. Many people want to use the railway industry, and millions of people have no viable choice.

Second, will the railway industry be regulated? Does it need to be regulated? Yes. These are services of importance to the public interest. The concentration of my office, the Office of the Rail Regulator (ORR), is on the monopoly and dominant elements of the industry. Our jurisdiction in that respect is considerable. There is no question that monopolies and dominant players should be subject to checks on the possible abuse of their market power. That means regulation in the public interest by a regulatory authority operating according to clear statutory criteria.

Thirdly, will that regulation be independent? Does it need to be? Well it does not need to be independent, but I will explain why I think it should be and why I think the Government accepts that it should be.

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The regulation of train operations does not need to be independent. And it is not independent. Why? Because the train operators have contractual protections in their franchises. Those franchises cannot be amended unilaterally, the discretions of government under those contracts are, of course, circumscribed by the contracts, and there are rights of compensation for breach.

The regulation of infrastructure provision need not be independent, but the alternative is very unattractive. The problem is that if you were not to have infrastructure services regulated independently, you would need some form of long term contractual commitment between the state and the private sector company or companies providing the infrastructure services. That contract would need to specify in detail the nature, quality and extent of infrastructure services to be provided and the price to be paid for those services. There would be considerable difficulty and complexity in specifying in an economic and efficient way how changes to the provision of infrastructure services would take place over time, especially on a national network, and how they might be paid for. And there would be many other complications. It could be a very awkward, rigid and expensive way of buying infrastructure services.

The London Underground, a very much smaller system of course, has a large number of complex contracts specifying things in great detail for the provision of infrastructure services. But those contracts are not perpetual contracts. They are much more in the nature of franchises - time-limited ones. In a contract-based approach, it is also necessary to put in essential protections for those who use and depend on the network which is being provided under contract to the state. This is because these train operators - they are mostly, but not exclusively, passenger and freight train operators - do not themselves have contracts with the state in relation to the provision of infrastructure services. Yet they need to be sure that in order to be able to meet their contractual commitments to their customers (including the Strategic Rail Authority (SRA)), the infrastructure they depend on and use will be in good shape and infrastructure services will be competently and properly delivered at a fair and affordable

price. That is another major complication which can be avoided by a non-contract approach to the regulation of infrastructure services.

Review of railway structure

On 19 January 2004, the Secretary of State made a statement to Parliament about a review of the railway industry, and the Number 10 Press Office issued a statement headed “*Rail industry faces fundamental review*”. It sounded like it is going to be very wide-ranging.

I have been in office as the Rail Regulator now for four and a half years. In that time, the jurisdiction of the ORR has always been under question. It was under question in the run-up to what became the Transport Act 2000. It was under question - very serious question - in what we now affectionately call the ‘Byers Bill’ of 8 October 2001 (that was the one which was not published but which was intended to be introduced into Parliament a week later to take the ORR under direct political control in relation to all of its functions, and which was not proceeded with following strong pressure from the industry and financial markets). Then the Government embarked upon a review of rail regulation from 15 October 2001 to 12 June 2002, culminating in Alistair Darling’s statement that they had had a good look at it and they did not think there were any changes required apart from the creation of a regulatory board instead of the single-person regulator model (I will return to that statement). Then ORR was under scrutiny again in the run-up to the Railways and Transport Safety Act 2003. Now we have to do it again in a five-month review announced by the Secretary of State two days ago.

This review, I have no doubt, will bring out the old arguments about vertical reintegration, reducing the jurisdiction of the Rail Regulator, stopping the Regulator ‘writing cheques on the Chancellor’s cheque book’, the assertion of a high degree of central state command and control over the railway industry, the merger of the ORR with the SRA, and so on. The Cassandras will parade their ignorance, their

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vendettas and their prejudices. The industry will resist distractions and diversions from their day job - which is, let us remember, providing quality services to passengers and freight customers - and there may well be a Bill at the end which will make some changes, if they are needed. These things often start with a roar and end with a whimper. And sometimes I do wonder when the Government will stop reviewing the railway industry and let it get on with its job.

Let us remember this. This is a private sector industry. This is not an industry in the public sector. It is not the national health service, the prison service, the police or the military, all of which are owned by the state. It is not for the Government to tell private sector companies what to do as if they owned them. And I do not believe that is what the Government is planning to do. The Government does not own the railway industry. The Government knows that it does not own the railway industry. Some people make that mistake, and I will come back to that.

The Government does have - and should have - a legitimate interest in the efficient and effective operation of the railway industry, just as it does with other regulated industries, such as energy, water and telecommunications. They are regulated in the public interest. So is the railway industry. That is what is necessary. But the impression is too often given that the railway industry belongs to the state. The state sold the railway industry in 1995 to 1997, and as far as I can remember it has not bought it back.

A few days ago, a Labour MP asked me for my views about the difficulties of regulating a company limited by guarantee - a company without shareholders - and how much easier, in my view, and more efficient and effective it would be if this company, the infrastructure provider, were a conventional company limited by shares. This Labour MP asked me whether I was suggesting by these remarks that Network Rail should be privatised! I patiently explained to him that the last time I checked the company was in the private sector, it was placed in the private sector seven years ago, and it is still there. But the mindset of so many commentators, politicians and others is that

Network Rail and the national infrastructure is owned, and therefore controlled, by the state.

The correct position, as we all know, is that the railway companies are owned by the private sector, they are rightly accountable to the public interest through their contracts with the state, the franchises, and the regulatory regime - the Railways Act 1993, the Transport Act 2000, and the licences and codes and other instruments made under them.

It is right, as I have said, that the industry is accountable. Railways are essential services. Railway facilities are essential facilities. It is uneconomic to replicate them. And so they must be regulated. But regulation is not the same as control. Network Rail is a private sector company, and it should behave as such. It is accountable to its customers under its contracts, and to its regulator under the law. It is not, and never has been, subject to direction and control by the Department for Transport (DfT) or any of its agencies.

I think we should bear in mind the cardinal rule of industry restructuring. I was recently speaking to an international audience who were contemplating railway industry restructuring in other countries, the establishment of regulators, and basically trying to get private sector investment in to reverse years of decline and to improve the quality and efficiency of the delivery of railway services (because that is why governments do these things). I made this point, and it was readily accepted. The most important thing, when you are doing an industry restructuring and preparing for private sector investment, is to design the structure correctly at the beginning, and then avoid making material changes later. You must, of course, have a process of evolutionary change, so that things that are established at the very beginning are not set rigidly in stone. But the idea of radical structural change years later, after the private sector has been brought in, should be avoided if at all possible.

Private sector investors do not like uncertainty and shocks. It should be remembered that some companies have put a lot of money - private sector money - either debt from nervous banks or shareholders'

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money - into new rolling stock, for example. EWS did this with its new fleet. It did so on a particular basis, one of stability and certainty, one of confidence in the independent regulatory regime and the checks and balances of the contractual and regulatory matrix.

What the railway industry - every industry - and private sector finance need is stability, predictability, clarity of responsibility and accountability, fair treatment and an environment which is friendly to investment.

Independence

One of the fundamentals is that economic regulation is independent because it needs to be independent. When the Byers Bill was thought to be about to be published, on 12 October 2001, the railway industry wrote to the Secretary of State for Transport a very powerful letter. What it said was the private sector came into this industry on a particular basis, and one of the fundamental cornerstones to investor confidence - and the conditions on which they were prepared to stay in the industry and to maintain their investments - was independent economic regulation. Some things were absolutely central, and that was one of them. What they said to the Government was: *“if you change that, then you will be doing great harm”*. In fact, the letter was drafted by Richard Bowker in his previous incarnation, and I have no expectation that he has changed his mind. It was signed by him and by the chief executives and chairmen of all the passenger train operators and by the chief executive of EWS. I had no part in the drafting of that letter; I only became aware of its existence after it had been sent. But I agreed with everything in it.

On 5 April 2001, in the House of Lords, the Minister of State, Lord MacDonald, said that the roles of the ORR and the SRA are different and their jurisdictions do not overlap. The importance of the independence of the ORR was stressed repeatedly by Ministers when the Transport Bill was going through Parliament in May 2000, and it has been emphasised and supported three times by the present

Secretary of State: when the seven-month review, started by Mr Byers and finished by Mr Darling, concluded in June 2002. He said it again when he made a statement to Parliament on 15 December 2003. And he said it again when he announced the present review on 19 January 2004.

I think it is pretty clear from all this that the independence of the ORR being undermined or changed is not on the cards. Some things in this review have been ruled out and the loss of independence for ORR is one of those things.

That means that merger of the ORR and SRA is out, because you cannot merge an independent body and a non-independent body and retain the independent status of the organisation. This is something that appears to have been lost on the Institute of Public Policy Research, Dieter Helm and a number of other commentators. What would you do? How could you merge the independent and the non-independent: retain political control of the non-independent bit, and keep the independence over the other bit? Would this new body be independent in the afternoons? It would be like having a football match where the referee plays for one side. It is incoherent. It is ignorant of the essential continuing requirement for independent economic regulation, which is a fundamental part of the Government's policy for the railways in its statement in June 2002, and now endorsed by the Secretary of State in December 2003 and January 2004.

Yesterday, the Organisation for Economic Co-operation and Development (OECD) published its report on the UK economy. In the section about the railway industry, it said:

“An important function of the Regulator is to ensure that private investors receive a reasonable rate of return provided that the company behaves in an efficient manner. [This is the infrastructure provider]. The independence of the Regulator is important in reassuring the private sector that it will not be subject to arbitrary political interference,

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thereby encouraging private investment. Without shareholders [this is talking about Network Rail] it is hard for the Regulator to discipline a company that simply passes bills onto passengers or the Treasury. Hopes of leveraging in large amounts of private capital have been greatly diminished by recent events, as the framework is too vulnerable to political interference. If the Government hopes to raise substantial amounts of money from the private sector, it needs to be clear as to how this can be achieved in the current setting. On the other hand, the case for an independent Regulator that sets the outputs expected for a given level of funding, and protects legitimate third party interests, is even stronger. The Government should clearly define the lines of responsibility and reinforce and ensure the Regulator's independence”.

I entirely agree.

Jurisdiction

Independence is fine. But there are two aspects to the ORR's status which need to be considered: independence on the one hand, and jurisdiction on the other. Jurisdiction is important because it is all very well being independent but that does not do you - and, significantly more important, the people who rely on you, such as private sector investors and the capital markets generally - much good if you have not got very much to do.

If you take the key functions of the ORR, such as access, competition law, licensing and licence enforcement, and of course the financial framework - access charges reviews - and transfer them somewhere else, then there is not much for ORR to do. It is still independent, but you have defeated what you were supposed to be trying to protect.

The Secretary of State's statement to Parliament on 19 January 2004 mentioned wrangling between various bodies in the railway industry,

and overlapping roles and responsibilities. Could that really be a description of the relationship between the ORR and the SRA?

In February 2002, the chairman of the SRA - Richard Bowker - and I signed a concordat on behalf of our two organisations. The concordat made it very clear that there is no regulatory competition and no regulatory overlap between our two organisations. In paragraph 3 of the concordat, we committed ourselves to promoting “*clarity over our roles and responsibilities, recognising our discrete, separate and complementary jurisdictions and statutory duties, and the absence of regulatory overlap or competition*”. The concordat was then publicly endorsed by the Secretary of State, Stephen Byers. When the October 2001 review of rail regulation finished in June 2002, Alistair Darling - the new Secretary of State - endorsed the concordat. He endorsed it again in a letter to me from the permanent secretary of the Department for Transport on 16 December 2003. Therefore it cannot be that there is an anxiety on the part of the Department for Transport that there is overlap and competition between the ORR and the SRA, because the Secretary of State has already said several times that there is not any.

So, is there nothing to be changed as between the ORR and the SRA? Well, yes there is. This is about behaviour. This is because there are - or there are capable of being - distortions in the dynamics of accountability, through the behaviour of the two organisations.

I give you an example. The network output specification document which was published by the SRA in August 2003 had a rather misleading effect on some parts of the railway industry, and on those who do business with the railway industry. Perhaps it was not intended to have these effects, but it had them. EWS's freight customers were very concerned when the SRA's document spoke in mandatory terms of the downgrading of particular lines - lines which were already being used for freight traffic, or which were needed for increased freight traffic - and they made anxious representations to EWS about it. EWS strove hard, and I think successfully, to deal with these, but its customers were seriously concerned and misled.

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I give just one more example. Very recently I was told by a middle-ranking manager at a passenger train operating company of a discussion he had had with his opposite number at Network Rail. This man from the train operator had been saying to his opposite number at Network Rail that he was dissatisfied with - and had better ideas for - the way in which the particular line in question in his area should be maintained and renewed. He was pointing out opportunities for greater efficiency, synergies, and how the impact of the work on his services could be reduced, how things could be done more economically and efficiently, and so on. The Network Rail person said: “*No, no, no, I can’t accommodate your concerns because I have been told by the SRA, through its network output specification, what I am to do. The network output specification is a statutory instrument with the force of law. It supersedes any relationship I may have with you, my customer*”. As we all know, the Network Rail man was dramatically wrong about that. But it shows how the dynamics of accountability can be distorted, and how important it is that they are not.

It is necessary for the relevant institutions in the railway industry to do the jobs which Parliament has given them. The Permanent Secretary’s letter to me of 16 December 2003 endorses that. It says the Secretary of State believes that “*the boundary lines between the roles and duties of the ORR and the SRA should be understood and respected*”. I entirely agree with that. And, if that is done, I believe it is clear that there is no case for transferring the jurisdiction of the ORR in any material respect to another body. Investors, capital markets and others need that to be made quite clear.

What else do we see in the Secretary of State’s statement? In paragraph 38, the Secretary of State said, “*It must be for the Government to decide how much public money is spent on the railway and to determine priorities*”. That is not phrased in terms of a consultation proposition. It reads as a statement of decided policy.

At first sight - and I stress, at first sight - this would not be consistent with the continuation of the private law indemnities in favour of the

private sector passenger train operators in the franchise agreements. Those are indemnities which are unlimited in amount, and limited only by the duration of the contract in question. This is a matter which the Secretary of State explicitly acknowledged in his 15 December 2003 statement to Parliament.

So what could the Government intend by this statement? I think there are four options, and the first two should immediately be ruled out. The first is that the Government intends to procure that the SRA will break its contracts of indemnity in the franchise agreements. That is an extraordinary and unimaginable proposition.

The second is that the Government intends to legislate so as to cap - at a level set by the Government - the access charges which the ORR may decide upon in an access charges review, despite the arbitral role of the regulator in that case, and the fact that the indemnities in the franchise agreements are uncapped. That would be an action of considerable constitutional significance, and it would carry profound implications for the sanctity of contracts between the state and the private sector.

The third option is that the Government intends to stop the SRA signing any more open-ended indemnities in future franchise agreements, and will possibly buy out the existing indemnities. That would then transfer to the private sector train operators a part - perhaps a material part - of the risk that the infrastructure will require more money than the Government is prepared to put into it in the future, even though the private sector operators' contracts with their customers and funders require a higher level of infrastructure provision. I will come back to that.

The fourth option is the Government intends to ensure that in future it - or its agency - comes up with a coherent and properly worked out plan for the franchising of passenger services and the giving of grant assistance to freight operators, and that that plan should take full account of the likely future costs of the infrastructure which will be required by the plan, so that the independent regulator - in

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establishing the size, quality and efficient cost of the network in an access charges review, as it must - can ensure that it comes up with a set of network outputs, and so charges, which are consistent with what the Government's plan for franchising and freight assistance implies. It seems to me that the fourth alternative is the most likely as to what the Government really means here.

As I said, the first two options - breaking contracts or constraining the ORR's powers in an access charges review (a kind of arbitration in which the Government is an interested party) - must surely be ruled out. Their constitutional significance would be immense, and no British Government could realistically contemplate it. That conclusion is reinforced by the Permanent Secretary's statement in his letter on 19 January 2004 to the UK rating agencies. That said that all contracts will be honoured. He also assured the agencies that "*nothing in this review will change the rights of third parties which will be protected*". That is an important statement which I welcome.

The third option - no more indemnities - is not feasible if there is going to be any prospect of franchising passenger railway services at economic cost. If the private sector operators were denied those indemnities - which, as I have said, are unlimited in amount - or they were capped, then they would be taking a serious risk. I think we can probably rule that one out too. That leaves the fourth option: a sound and sufficiently specific - and therefore useful - franchising and freight grant strategy produced in good time to inform an access charges review by the ORR. That must be the one they mean.

It is sometimes objected that the ORR should not have the right to determine that the network should be bigger than is needed, that it should not have the right, for example, to double the size of the network at its discretion, and then set access charges at some very large amount accordingly. This is said in many quarters. Disappointingly, it also appears to be believed by some people who hear it. But it is not true. I do earnestly hope that this review will take place on the basis of real facts and not imagined ones.

In an access charges review, the ORR has to establish what are the reasonable requirements of operators and funders, having regard to the contracts which they have and the contracts they are likely to have for the use and the development of the network. It must also do this having regard to the interests and the long-term sustainability, efficiency, economy, growth and development of the network - those things which are likely to be required. The ORR cannot go beyond those considerations. It cannot speculate wildly. It cannot act arbitrarily. It must act rationally, on the best information that it has at the time.

That brings me back to the role of the SRA and the Government. The Government must ensure that the regulatory authority is provided with the information necessary to make its decision. That requires - and I made this very clear at the beginning of the 2003 access charges review - timely and competent input from all the relevant stakeholders.

The ORR is also required - by section 4(5) of the Railways Act 1993 - to have regard to the financial position of the SRA in making its decision. That, of course, requires the ORR to know what the SRA's financial position is. This financial power of the ORR - the way it is colourfully put is that 'the ORR can write cheques on the Chancellor's cheque book', that this is 'a constitutional outrage' and the like - I think that is just nonsense.

Where does the power of the ORR to do these things come from? The ORR establishes the reasonable requirements of customers and funders, as I have said, and sets access charges accordingly. That is what every economic regulator does. The water regulator does it, the telecommunications regulator does it and the energy regulator does it. The customers in these industries have to pay the higher charges, if that is what the regulator decides. Look at the water industry, where bills have in the past gone up by a lot because the infrastructure needed more, and they may go up by a considerable amount again for substantially the same reason. That is what has happened in the railways, because the infrastructure needs more.

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Of course not everything the infrastructure provider wants and demands he gets. What regulator would ever give that? The charges are determined according to what a competent, efficient, well-managed company can reasonably be expected to achieve. That is what the ORR does. And the passenger train operators have to pay the higher access charges which the ORR has set.

These customers of the infrastructure provider - the train operators - are in a fortunate position. They have got a contract with the state. That contract says that if the independent regulator who is arbitrating a particular question - what does the network need and what should the charges be? - raises access charges, we, the state, will indemnify you, the passenger train operator, against the full amount of the increase. That is entirely unobjectionable.

These indemnities were not established by the Regulator. They were not approved by him. They are not enforceable by him. They are really not very much to do with him. They come about because the Government, for entirely legitimate public policy reasons, decided that it was necessary to indemnify the passenger train operators against this risk. It did so in private law contracts voluntarily entered into by a sovereign government.

Indemnities of this kind are entered into by the public sector - whether central government, or agencies, or local government - all the time. When schools, hospitals, prisons, aircraft carriers, missile systems and tanks - whatever the public sector wants to buy - get bought or built, in the procurement contract there is an allocation of risk between the buyer and the seller in relation to the product. In some respects there is provision for the arbitration of a question, and that arbitration, to be fair to both sides, is determined by an impartial arbiter. What is wrong with the Government contracting to say that if certain - as yet unforeseen - circumstances come about it will take the financial responsibility for the consequences or a defined proportion of them, and then being expected to honour that obligation? There is nothing wrong with it. It is conventional and competent contracting policy. How can it be that the Government can very properly do this in other

industries and yet it is objectionable or unconstitutional for it to do it in the railways?

Those who complain about the ORR's ability to raise access charges - on the grounds that the increases flow through to Government by virtue of voluntary contracts made by the Government - should stop complaining. The Government chose to enter into these contracts of indemnity. If the Government does not like the fact that it has these indemnities, it could go for the third option that I mentioned earlier. That is to buy out the existing indemnities - most of which have very little time to run so it would not cost very much - and stop signing any more. For the reasons I gave earlier - concerning the Government's ability to franchise passenger services - they will not.

Indeed, this is the reason the policy of indemnification in the franchise agreements entered into by the Conservative government's agency, the Office of Passenger Rail Franchising (Opraf), is being continued with now - in the new generation of franchise agreements - by the Labour government's agency, the SRA.

I think it is very important that the realities of the ORR's jurisdiction are acknowledged and respected.

Network Rail is going to the financial markets very soon in connection with its own financial position, and its proposed securitisation. The financial markets need to have certainty, stability and predictability, and therefore they need to know whether the jurisdiction of the independent economic regulatory regime on which so much depends is going to be changed.

This is the situation that was faced 18 months to two years ago. To get Railtrack into administration on 7 October 2001, nothing much was said in court that day about the ability of the independent economic regulator to do an interim review and so restore the company's financial position. That was a process in which the court was told that the company was insolvent. By contrast, to get Railtrack out of administration a year later, quite a lot was said in

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court about the ability of the independent economic regulator to do such a review, to demonstrate the solvency of the company. By then, I had said in a public statement in September 2002 that I was willing to do an access charges review - the review I finished in December 2003.

In May 2002, I had a conversation with Sir Richard Mottram, who was then the permanent secretary at the Department for Transport. This was when the Government's review of rail regulation was taking place. I said:

“Richard, I am going to have to make a statement about my approach to the regulation of the new infrastructure provider, and my willingness to do an access charges review. You need that to get Railtrack out of administration and for Network Rail to raise money to refinance the company. I can do all that - I will do all that - but there is an elephant in the room. In October 2001, the Government started a review of my jurisdiction and independence, and here we are in May 2002 and I still don't know when this review will come to an end or what you are going to conclude. I can put in paragraph 1 of my statement to the financial markets a statement to the effect that there is this elephant in the room”.

And Sir Richard said, in effect, *“wouldn't it be much better if we got the elephant out of the room before you make yours statement”* - and so they did.

Therefore, on 12 June 2002, the Secretary of State made a statement to Parliament saying that the Government had carried out a review of the regulatory regime for the railways and it had come up with five overarching principles. It said the most important of them was *“providing sufficient comfort and protection to operators and lenders through independent economic regulation and in order to regulate monopoly/monopsony elements and to secure private investment in the railways at an efficient cost”*. It described it as *“an essential*

continuing requirement". The Government said that, having done the review; it was not going to make any changes to the rail regulatory regime except for the creation of a regulatory board - bringing ORR into line with all the other regulators like Office of Fair Trading (OFT) and broadcasting, energy and so on - moving from the single-person regulator model to the board model. I will come back to that. Apart from that, there were to be no other changes. Of course that statement to Parliament cleared things up, and therefore the statement I made about the regulation of Network Rail and the coming access charges review was one from which financial markets and others could take considerable comfort. They say that the regulatory regime was stable and supported by the Government. That is what they needed to know.

Now, in early 2004, Network Rail is making another approach to the financial markets for potentially a lot more money. In 2002 they were going for £9bn to re-finance Railtrack's debt. Now they might be going for more. But there is another review going on. I believe it is necessary for the Government to make it plain what are the parameters of this review as it may affect any diminution of the jurisdiction of the ORR.

Safety

It is, of course, a different matter when you consider *adding* to the jurisdiction of the ORR. Safety is often the candidate. Her Majesty's Railway Inspectorate (HMRI) is thought by some to be ill-housed in the Health and Safety Executive (HSE) - they say it is not in the right place. It was moved in there only recently and perhaps it should go somewhere else. That is what is said.

There are a lot of people who propose that the HMRI should come to the ORR, on the model of the Civil Aviation Authority. However, the Cullen report into the safety regulatory regime for the railways ruled that out. But, despite Cullen, it is possible to put the two together and there are those who say there are advantages in doing so. There is,

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however, some overlap between the Railway Safety and Standards Board, which is established under the network licence, including the ORR's jurisdiction for the establishment of the code for mandatory and technical standards, and the jurisdiction of the HSE/HMRI. But if this fusing of safety regulation and economic regulation is to be contemplated, considerable care is going to be needed because of the ORR's appellate role in relation to Railway Group Standards. That is sensitive. It raises complex and difficult issues.

Regulatory board for ORR

As I have explained, in line with other regulatory authorities, the Rail Regulator is to be turned into a board. Chris Bolt has been named as the non-executive chairman of the new ORR board which takes over from me on 5 July 2004. I have invited Chris to come on to the non-statutory ORR board with immediate effect, so as to ensure, as much as possible, continuity in the six months before the new statutory board takes over. I am very pleased that Chris has accepted my invitation.

The statutory board is going to be made up of a non-executive chairman, a full time chief executive, a majority of non-executive directors, and the existing executive directors of ORR. That adds up to nine.

Establishing a statutory regulatory board will change the dynamics of decision-making in regulation. That is why it is being done. There are some difficulties with this. There are difficulties arising out of the complexity, diversity and urgency of the issues which face a regulatory authority. It is not a simple matter to transfer to a regulatory authority the technology of a corporate board which is suited to a company operating according to commercial principles and usually in a competitive environment. It is not impossible - it has been done with success in other cases - but it is not that easy.

I might add that I expect that the Kremlinology of regulation in the railway will become far more interesting with a nine-member board. People outside - stakeholders of all kinds - will be trying to work out who are the board's hawks and doves on particular issues, building coalitions, consensuses, compromises, voting blocks to stop things, alliances to push some through. I expect they will have great fun speculating on all this!

Will this make for strong and decisive action in difficult cases? I hope it does not diminish the ability of the existing model to act decisively and quickly. I expect that that is one of the matters which Chris and his colleagues will be addressing as soon as possible. It is very, very important that the ORR - with its independence and jurisdiction intact - operates efficiently and effectively. I have every confidence that Chris and his colleagues will do everything they can to ensure that it will, but it is not going to be as easy as it was when I took over ORR in July 1999.

Sound financial footing for Network Rail

Through the access charges review 2003 - the final conclusions of which I announced on 12 December 2003, and the formal review notice signed on 23 December 2003, which started the process of implementation of that review - Network Rail has now got what it most needs: a sound, fair and sustainable financial framework. It now has stability and predictability. It has a clear set of outputs, a clear set of performance targets, a clear set of accountabilities and the certainty that the money that it needs to do this job is coming in. It is now up to the company to get on with the job.

The access charges review 2003 has achieved all that. That is something that Network Rail did not have before, nor did its predecessors for three years. We had a lost year after the Hatfield accident in October 2000, when the integrity of the network disintegrated and Railtrack just spent money like water. Then we had the year of Railtrack's administration, when the engineers at Railtrack

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thought that now that the equity had been extinguished there was no reason why they should not spend, spend, spend. Remember that during that time the company was being administered by four accountants - able people, no doubt, but not railway professionals. Costs exploded, performance plummeted; it was truly a lost year.

Then Network Rail took over and they had a year getting to grips with the company. They thought they were taking over a problem child - they certainly were - but they did not know it had a whole raft of anti-social behaviour orders against it as well! It *was* a problem child. But the new management of Network Rail is energetic and is getting to grips with many of the difficulties which the company faces. It still has a great deal to do, and a steep mountain to climb.

Final part of Access Charges Review 2003

As far as the 2003 access charges review is concerned, there is one piece of the jigsaw which has yet to be put into place. About two weeks before I made my final decision and announced it, the Government and its agency, the SRA, said that they would like to alter the mix of access charges and grants. This was - and is - because access charges income - which is paid by the SRA in subsidy payments to the franchisees, and then they pay it over in access charges to Network Rail - is the wrong kind of money (we have had the wrong kind of snow and the wrong kind of leaves, now this!). However, if the Government's money which ends up with Network Rail were to be paid by way of grant under section 211 of the Transport Act directly by the SRA to Network Rail, it would count as capital. From the Government's point of view, that would be the right kind of money. Capital payments would not violate the Government's golden rule in terms of the economic cycle. This has been put to ORR as a strong government accounting reason for paying the additional money for Network Rail in capital grants.

Does it matter to Network Rail how the money comes in - whether it comes in through the train operators or directly from the SRA? It is

said that it does not really matter as long as it is indistinguishable from access charges - as long as Network Rail know they are going to get it. However, there are some difficulties. The Government wants me to allow the income going into Network Rail to be 80% grants and 20% access charges. That is a big proportion of grant income.

My reaction to this approach was that I could not decide the issue in so short a time. I therefore said that I would put off that aspect of my decision in the access charges review until 29 February 2004. On or before that date, Network Rail may come to the ORR with a proposition in two parts. If it does, and the proposal is acceptable, the access charges going in may be reduced because the company will be receiving money in other ways.

The first proposition is likely to be that the company does not need as much money in the first two years of control period 3 (CP3), beginning on 1 April 2004, because it has been able to borrow it in the financial markets. The amount borrowed can instead be added to the RAB. The company is going to have to take soundings in the financial markets before it can be confident of that matter, and that is why they need to go to the ratings agencies and the financial markets quite soon. But in the access charges review I made it plain that the longest period of borrowing in this respect should be two years' income. In year three of the new control period, the company has got to be getting all its money through grants or access charges.

The other proposition which the company may make to me by 29 February 2004 concerns a different mix of access charges and grants. It could be 80:20, 70:30, 50:50 or some other proportion.

In both cases - the two years' borrowing and the different mix - the company must first have reached agreement on the proposal with the Government and the SRA. Unless the company comes to ORR with a fully worked-up, acceptable proposal by 29 February 2004, from 1 April 2004 access charges will stay at the levels provided for in the review notice which I issued on 23 December 2003. Ignoring the declining proportion of grant income that still has to come in from the

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existing grant arrangements, that is at the rate of £5.125bn in 2004-05, declining to £4.843bn in 2008-09. It is very important that the dynamics of accountability are not distorted by any such proposition. The Government agrees with this. In his statement to Parliament on 15 December 2003, the Secretary of State said:

“The fact that a high proportion of Network Rail’s income may be provided as grant from the SRA does not mean that the SRA acquires any control or influence over the company. Network Rail must continue to operate at arm’s length from the SRA. It must focus on meeting the needs of its real customers, the freight and passenger operators. I am sure this point is understood by all concerned”.

That is what he said in his statement to Parliament. The next day, the permanent secretary at the Department for Transport wrote to me and said:

“The Secretary of State attaches considerable importance to the independence of Network Rail as a private sector company limited by guarantee, which is accountable to its members and subject to independent economic regulation. The Secretary of State views as essential the commercial relationship between Network Rail and its customers, who are the operators of freight and passenger services. The fact that income is received in the form of grant will not affect in any way the independence of Network Rail or disturb the company’s contractual or commercial relationships. The payment of grant does not create any obligation on the part of Network Rail to the SRA, or any right on the part of the SRA to seek to direct or influence Network Rail”.

In the implementation of the access charges review, we have put in some protections - automatic mechanisms - which, if triggered, will increase access charges by the amount in question.

First, if the SRA fails to pay any amount of grant then access charges will automatically rise. This does not require any action by the ORR - indeed the ORR could not act to prevent them rising, nor could anyone else - it would happen automatically.

Secondly, if the SRA attaches any conditions to grant payments, thereby seeking to direct or influence the behaviour of the company, then the access charges will rise automatically by the amount of the grant which is proposed to be subject to that condition. These grants have to be unconditional obligations of the SRA to pay the money to the company. The Government has stated that it accepts that fact.

What has regulation achieved?

I would like to finish with a brief review of some - only some - aspects of what independent economic regulation achieves, and has achieved, for the railway industry.

As I have explained, it achieves an insulation from political control, and the OECD values that very highly. It is essential that the decisions that are taken by the regulatory authority are free of improper political considerations. That is fundamental to the regulation of all network industries. It started with the Telecommunications Act 1984 and it continues today. It provides incentive regulation, as well as enforcement mechanisms, which is valuable. It provides stability, certainty and predictability in the finances of the industry. It provides very considerable comfort to the railway industry and investors, and this is essential for private sector investment.

Regulation as it is practised today provides fair access to essential railway facilities, on affordable terms, if necessary using compulsory means. It ensures efficient allocation and consumption of capacity of railway facilities.

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It provides flexibility in the controls, in the discretions, which need to be operated in accordance with the public interest. These are flexibilities which are not available in the contract model. They come through the process of modifying the network licence for Network Rail, or any other licence. Since I took office as Regulator in July 1999, I have added nine new conditions to Network Rail's network licence, a licence which was woefully weak and unsuitable for a private sector company at the time of privatisation. These new conditions concern matters such as the establishment of a network asset register, proper and proportionate assessment of the competence of stewardship of the network, fair dealings with third parties, the disposal of railway land, and so on.

Regulation has also achieved a true alignment of the interests of the train operators and the infrastructure provider, through the programme of establishing model contracts for access to the network and the industry-wide network code.

One of the things that has been rightly criticised - and it is one of the things that is mentioned in the Secretary of State's statement to Parliament two days ago - is the antagonistic relationship which was established at the time of privatisation through the access contracts between the operators and the infrastructure provider. They were set up to fight one another. They did not have aligned incentives. What ORR has done in the model contract regime is set up a true co-operative joint venture between train operators and the network provider. This is an acknowledgement of the intensity of the interdependence between the train operator and the network provider, so as to align their incentives, to make them face in the same direction, to want the same things. It maximises their opportunity to deliver a quality, efficient service for the benefit of passengers and freight customers. Those new model contracts come into force as the old ones expire. The first raft of them come into force on 1 April 2004.

We are also reforming the network code so as to make it fit for today's railway. This is essential if the common rules about

timetabling, the handling of operational disruption, changes to rolling stock and the network itself, and the provision of information are to be fit for purpose. That work will be complete before I leave office in July 2004.

This is all about bringing the train and the track into harmony. I might add that we would have completed this two or three years ago if it had not been for Hatfield and its aftermath, the collapse of Railtrack, the establishment of Network Rail and the need for another access charges review.

The regulatory reform programme that I have been carrying out and will shortly complete has been about empowerment. It is empowering the train operators in their relationship with the infrastructure provider. It has been about empowering the infrastructure provider in its relationship with the train operators. We have established local output commitments, which are contractually binding commitments established by the network provider on a train operator by train operator basis, which says clearly what is going to be delivered in their area and what happens when things go wrong. The industry really needs to take that seriously. I believe that it does. There needs to be buy-in from the senior management of Network Rail. The train operators and Network Rail need to pick up this instrument and use it.

The new Part K of the network code is going to be very important. It is about information. It is vitally important. Let me give you one example. I put it like this. Why should the network provider not tell the people who use and depend on its network what it is doing to that network, whether it is maintaining it to a high degree or hacking back on maintenance, and what is happening? Of course it should. It should always have done so. Part K will establish the necessary regime.

If GNER had had information from Railtrack as to what Railtrack was not doing on the East Coast mainline at Hatfield, it is possible that that accident could have been avoided. And Railtrack would have shared with the other operators elsewhere on the network the

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information necessary so as to avoid the disintegration of the integrity of the network after Hatfield. It is as serious as that. If Railtrack had known those things, and established its asset register (required under the new condition of its network licence established in April 2001), we would probably be facing a quite different set of circumstances today.

We now have a regulatory and contractual framework which is fit for what really matters - the competent, efficient and safe delivery of railway services to freight customers and passengers.

Conclusion

I believe that the present review of the railway industry is capable of being a constructive review focused on the things that do need to be changed. The ORR will engage in it constructively, positively and professionally.

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