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Nicola Shaw
Chief Executive Officer
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Dear Nicola,

ORR response to The Shaw Report consultation

We welcome your review into the future structure and funding of Network Rail. At a time when Britain's rail industry faces unprecedented growth and investment, your scoping report rightly focuses on customers, devolution, the impact of growth, network capacity and planning.

Great Britain's railway has seen a doubling in passenger numbers and significant growth in freight since privatisation. Our railways have a good recent safety record, and are today among the safest in Europe. At the same time, we have seen major improvements in the efficiency of the main network infrastructure. Our broad estimate of money saved by Network Rail is £10-£15 billion of efficiency savings since 2004 (Control Periods 3 to 5). By any measure, this is a success story for the whole industry.

Notwithstanding these successes, much of our key infrastructure now has very limited spare capacity, Network Rail's plans for improving passenger services are yet to deliver expected benefits and Network Rail must improve its enhancement capability if it is to deliver Sir Peter Hendy's recently published plan.

There are many diverse views on the future of the industry. As the independent regulator, ORR's objectives include driving for a safer railway, supporting a better service for customers and securing value for money for users and funders. But the size, structure and funding of the rail industry is a matter for government, not the regulator.

We agree with your scoping document that identifying the right industry structure is the logical starting point for addressing the challenges facing the industry. With clarity over objectives, and a vision for the overall industry structure needed to achieve these – including funding and financing arrangements – it is then appropriate to consider the role of the regulator from first principles. Regulation must be considered as part of the whole system taking account of the different organisations which make up the system, the incentives which shape their behaviour and which together deliver the desired outcomes for passengers, freight customers and taxpayers.

The need for independent regulation of public utilities

The case for a body that is able to act independently of the industry it regulates is well understood across several sectors that are dependent on network monopolies for accessing markets, including gas, electricity, water and railways. The case in favour of a body which is also independent of government, even where it shares the high level objectives that governments set for customers and taxpayers, is based on the same principles and a recognition of the incentives which shape governments' behaviours and actions. These principles are internationally recognised, both in EU law, and in the work of the OECD and apply across many sectors.[1] They can be grouped around three key reasons:

1. **To ensure current users and funders of the network are not disadvantaged by its monopoly power**

   A network is a monopoly and as a result does not have the same incentives to meet the needs of its customers that a firm operating in a competitive environment does. This is the case whether the monopolist is publicly or privately owned (although the behaviours will be different.) A body independent of the network is essential to give confidence to current users and operators that the network is being consistently and transparently held to account for the efficient delivery of the outputs which they require and that they are being treated fairly.

2. **To ensure access to the network is on a fair basis**

   It is essential to create a framework that gives confidence to the different users and different funders that they will be able to access and invest in the network on a fair, transparent and predictable basis. This will directly and indirectly underpin investment in the industry.

   The users and funders of networks are becoming more diverse. They place different demands on the network and can operate in different markets. In railways, there are long distance passengers, inter-urban passengers, commuters, locally-sponsored social services and freight customers all requiring access to the same network. Where there are multiple public funders, there will be times when they have competing aspirations for the same part of the network.

   Governments (through franchising), devolved local governments, train operating companies and freight operating companies all want to specify the requirements of their customers before they make long term commitments in the public or private sector.

   An independent body, acting within a legal framework that sets out the overall objectives for the railway sector, is able to take decisions which are objective, impartial and transparent providing the confidence which public and private funders of the railway require to invest.

[1] OECD (2014), *The Governance of Regulators,* Best Practice Principles for Regulatory Policy

3. **To protect the interests of future users and funders in an industry of long-lived assets**

   In any industry where infrastructure assets last for decades, efficiency depends on taking a whole-life-cost perspective. Under-investment today increases costs of funding in the longer term. It also increases the risk of poor asset performance and asset failure in the future leading to reduced capacity, reduced quality of service and concerns about safety.

   An independent regulator is an important safeguard of the interests of future users and funders because it can oversee the long-term sustainability of asset condition, holding the monopolist to account for the long-term consequences of its decisions. In the rail sector, we consider the future safety of the network a key part of this judgement.

   Linked to the need to take a long term view, it is essential not to lose sight of the benefits from the current five year planning and funding framework, which has helped turn Britain's railway into one of the most successful in Europe. While an even longer term planning horizon is needed for large projects, the five year cycle has served to insulate operations, maintenance and renewals expenditure from annual or in-year budget fluctuations. Crucially, it has served as a mechanism for reconciling the volume of activity government wishes to secure with an independently assessed view of the funds available to an economic and efficient provider.

   The government's recent roads reforms have at their heart the rationale that increased funding certainty, combined with greater institutional freedom from government on non-strategic, day-to-day matters, is essential to achieve efficiencies. An independent body overseeing a multi-year settlement is the model with a proven track record of securing steady investment in UK public utilities.

Our toolkit as a regulator

The way in which independent regulation delivers the above principles will depend on the funding arrangements, incentives and information flows that support the chosen industry structure. Although it is difficult to offer specific suggestions until the industry structure is clearer, as the National Audit Office report on rail regulation observed, value for money for users and taxpayers depends on effective incentives and accountability, specifically:

- strong incentives on Network Rail to achieve efficient and sustainable levels of cost; and
- robust information to judge what level of cost is efficient and sustainable, and how Network Rail's performance compares with that efficient cost.[2]

Shortcomings in either of these areas reduce the effectiveness of regulation. Our recent and ongoing work in preparation for the next periodic review of Network Rail shows how the regulatory toolkit could evolve, alongside industry reform. Our consultations on the

[2] National Audit Office (2011), *Regulating Network Rail's Efficiency* (see in particular paragraph 4)

system operator, review of the structure of track access charges and response to the Competition and Markets Authority on competition in passenger rail services are particularly relevant. Links to our published documents are provided in the annex.

Yours sincerely

Richard Price

Annex: Links to relevant ongoing ORR work

System operation – a consultation on making better use of the railway network

Network Charges - a consultation on how charges can improve efficiency

ORR response to CMA consultation on competition in passenger rail services