

ORR response to DfT Call for Evidence on rail regulation

1. Introduction

Regulators need to reflect the changing realities of the industries they regulate, and the changing needs of customers and wider society. In rail, the reclassification of Network Rail has changed its accountability to, and its financial relationship with, the Department for Transport (DfT). In consequence, reclassification has also changed the role of regulatory incentives on Network Rail. ORR's approach to regulating Network Rail needs to adapt to this environment and, any decisions about the future structure of the industry taken following the Shaw Review.

The scope of this response concentrates on the economic regulation of mainline rail infrastructure, which is the focus of the Department for Transport's project. This response is structured as follows:

- **Summary**
- **The case for independent economic regulation**, which is relevant to the DfT's first two key questions "*In the light of Network Rail's reclassification, does the role of the regime remain valid?*" and "*Are the ORR's present statutory duties appropriate?*"
- **How rail regulation could evolve**, including issues relevant to the DfT's third and fourth key questions *on competition, protecting passengers and governance arrangements*.
- The **Annex** provides references to relevant documents

2. Summary

The need for independent economic regulation

The DfT asked whether the role of the regulatory regime remains valid following Network Rail's reclassification and whether the ORR's present statutory duties are appropriate. There is a strong case that independent economic regulation, along with duties that balance the needs of different stakeholders (passengers, freight users, taxpayers, and rail industry), continue to be needed regardless of the public or private classification of Network Rail.

Three key principles sum up why independent regulation is needed:

- To ensure current users and funders of the network are not disadvantaged by its monopoly power.
- To ensure that customers' access to the network is awarded on a fair and consistent basis.
- To protect the interests of future users and funders in an industry of long-lived assets.

Regulation must be underpinned by direct accountability to Parliament; clear legal and functional separation from government and industry; transparent and objective decision making; access to information; and the ability for the regulator to balance its duties in a way that protects the diverse interests of customers and funders.

Evolving regulation

The DfT also asked how the regulatory regime can be made most effective, with respect to competition, protecting rail users and passengers, governance, accountability and efficiency. The reclassification of Network Rail and the Shaw Report mean the time is right to review the regulatory toolkit as it applies to the mainline railway.

Government decisions following the Shaw Report may have important consequences for the way regulation is most effectively carried out. Decisions on the ownership and financing of the network are particularly important. The right regulatory approach will depend on the nature of the industry's structure and funding. It will be necessary to:

- **Review the regulatory toolkit following decisions on ownership and funding structure.**
- **Clarify roles and responsibilities, including:**
 - In light of the reclassification of Network Rail, and following decisions on industry structure, whether it would be helpful to have a **Memorandum of Understanding between government and ORR**. This would be based on the BIS principles of Better Regulation, and clarify where the government's legitimate interest and ORR's statutory obligations overlap.

- **Responsibilities for planning and delivering enhancements.** Following the Bowe review, the new framework for enhancements planning, implementation and oversight needs to be understood by all parties and integrated with wider industry planning processes.
- **The arrangements to protect passengers and other users:** to ensure there is a comprehensive approach as the roles and responsibilities of different bodies are reset.

In the longer term, there may be scope for further structural reforms to promote greater competition in the market, following the Competition and Market Authority's discussion document on on-rail competition¹. In due course, greater competition would also affect the appropriate regulatory approach.

To provide better services to passengers and freight customers, ORR is considering options to reform the approach to regulation in the next Periodic Review (2018), and will be consulting on this in the spring. This will include a greater focus on the role of routes, ensuring the rail network operates more effectively as a system, and improving network charges and incentives.

Joined-up regulation

Alongside ORR's functions that are core to economic regulation, there are powerful synergies with ORR's functions in respect of health and safety, consumer protection, market oversight, and producing rail statistics. These are activities which will need to be carried out in any rail industry structure. For example:

- On health and safety, there is a close link between ensuring the network's assets are maintained safely and the performance of those assets.
- ORR's consumer and competition powers, which protect passengers, freight customers, railway operators and taxpayers – align with the principle that access to the network must be on a fair and consistent basis.
- The data generated for ORR's external statistical releases is largely the same data as ORR uses internally for regulating Network Rail and monitoring train operating companies' (TOCs) franchise and consumer obligations. There are significant synergies from keeping these functions in one place and not replicating the processes of collecting data and assuring quality.

There are also synergies with ORR's role as Highway Monitor, recognised by the DfT at the point when the new arrangements for the national road network were put in place. For example, through ORR's ability to develop benchmarking techniques, improve performance and efficiency monitoring, and ORR's ability to act as an informed adviser to governments.

This response concentrates on functions that are core to economic regulation, so there is not a separate section on joined-up regulation. ORR would be happy to provide further information on the approach to and rationale for carrying out these related functions.

¹ Competition in passenger rail services in Great Britain, Competition and Markets Authority, July 2015

3. The need for independent economic regulation

The DfT asked whether the role of the regulatory regime remains valid following Network Rail's reclassification and whether the ORR's present statutory duties are appropriate. There is a strong case that independent economic regulation, along with duties that balance the needs of different stakeholders, continue to be needed regardless of the public or private classification of Network Rail.

The DfT call for evidence recognises the importance of independent regulation of rail. This independence is underpinned by:

- A statutory framework, with legal and functional separation from day-to-day government activity, and direct accountability to Parliament.
- Legal and functional separation from Network Rail and from all other industry users and funders.
- Transparent and objective processes for collecting and publishing evidence and making robust decisions that are seen to be independent and will stand up to external scrutiny, including judicial review.
- Access to information and sufficient powers to act in a way that protects and ensures fairness between different users or funders.

The BIS Principles for Economic Regulation (2011)² emphasise many of these features and commit to preserve the independence of economic regulation. Any changes to ORR's role and responsibilities should seek to preserve and reinforce these features, as well as adhering to European law³ on independent regulation.

The case for a body that is able to act independently of the industry it regulates is well understood across sectors that are dependent on network monopolies for accessing markets, including gas, electricity, water and railways. The benefits of a body which is accountable to Parliament, but independent of government (even where it shares government's objectives for the industry) arise from the same principles. They can be grouped into three key principles.

(i): To ensure current users and funders of the network are not disadvantaged by its monopoly power

The rail 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 might do. This is the case whether the monopolist is publicly or privately owned, although the nature of adverse behaviours may be different in each case.

A regulator gives confidence to customers, funders and Parliament that the monopoly network manager is being consistently and transparently held to account for the efficient delivery of the outputs required and that they are being treated fairly. The UK recognised this during the separation of the rail industry which followed the

² https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31623/11-795-principles-for-economic-regulation.pdf

³ Directive 2012/34/EU of 21st November 2012 (recast)

1993 Railways Act by setting up ORR as the independent regulator of the network monopoly.

European law has subsequently recognised this principle as an essential condition of the vertical separation of rail markets. European law requires member to have a single national regulator that is independent of any other public or private body, along the lines of the UK model. In particular, the regulator is required to be independent of infrastructure managers and passenger and freight operators whether these are publicly or privately owned and operated.

Example: Holding the monopolist to account

ORR specifies the outputs and volumes of service that Network Rail is required to deliver in its final determination and holds it to account for these. A recent specific example is ORR's challenge over the volume of renewals work Network Rail agreed to deliver during Control Period 4 (2009-2014).

ORR identified that during Control Period 4, Network Rail consistently under-delivered plain line track renewals, finishing the period around 7% behind plan. ORR was concerned about the long-term implications of this shortfall, and required Network Rail to provide further analysis to assess the risks if the trends continued. This analysis showed there would be a further deterioration in track condition if the shortfall continued, and it would be difficult to recover the backlog without restricting the availability of the network. Reaching this common understanding with Network Rail's management has helped increase Network Rail's focus on recovering and preventing a backlog in track renewals. ORR's ongoing monitoring shows that after a slow start to CP5, Network Rail's performance in this area has improved and track renewal is currently on target.

Beyond this specific example, through recent monitoring and reviews, ORR has identified a range of opportunities for cost savings and has applied pressure to Network Rail to realise these savings.

(ii): To ensure that customers' access to the network is awarded on a fair and consistent basis

Different users and funders must have confidence that they will be able to access and invest in the network on a fair, transparent and predictable basis. This is essential to maintain confidence to invest in the industry by a diverse set of funders and to support investment in long-lived assets by customers (e.g. rolling stock, port facilities). Many take significant investment decisions on the basis of predictable access to the network.

Access claims on the network are likely to become more complex and contested as users and funders become more diverse. Across the UK there are freight customers, long distance passengers, inter-urban passengers, commuters, locally-sponsored social services and high speed services.

An independent body, acting within a legal framework of duties to have regard to the interests of all affected parties, but with preferential treatment to none, is essential if access decisions are to be objective, impartial and transparent. By supporting better use of the network and predictability in access to the rail network a regulator can also help minimise industry costs, and the need for lengthy dispute resolution.

Examples: Ensuring fair access

ORR has a key role in balancing competing interests and to make fair, evidence-based decisions. A recent example is ORR's approval of a new contract for franchise access rights to continue operating existing services. Network Rail had been reluctant to agree to these rights because it expected engineering works would lead to the suspension of some services: therefore it would have to pay compensation to the operator, even though these costs had already been included in Network Rail's funding. ORR's decision secured the continuation of passenger services and avoided a more protracted, costly argument about the terms of access.

Another example is Network Rail's desire to change contract terms to freight operators, requiring them to be much more flexible about train times. Flexibility will become increasingly important to Network Rail as it strives to optimise how capacity is used on an increasingly busy network. However, this could make it unduly difficult for freight operators to win and retain some types of customers and to plan ahead. ORR is currently considering the evidence on how best to balance these competing interests.

(iii): To protect the interests of future users and funders in an industry of long-lived assets

An independent regulator is an important safeguard of the interests of *future* users and funders because it can make judgements – independent of *current* users and funders – about the required sustainability of asset condition and can hold the monopolist to account for the predictable future consequences of its decisions.

In an industry where infrastructure assets can last for decades, efficiency depends on taking a whole-life-cost perspective. Expert judgements need to be made about demand and performance requirements over the whole of an asset's life, and the trade-off between renewals and maintenance to optimise the long-term cost and ensure reliable asset performance over both the short and long term, considering how these decisions affect users and the interests of different funders. Under or over-investment today could, depending on the circumstances, increase the costs of the asset in the longer term.

In the rail sector, past failures to focus on whole-life asset condition have hindered asset sustainability and the maintenance of a safe railway, increasing costs. The development of Britain's railways over the past decade has demonstrated how improvements in safety, performance and efficiency run hand-in-hand.

It is essential not to lose sight of the benefits of the current five year planning and funding framework. While an even longer term planning horizon is needed for large projects, the five year cycle (based on the Government's High Level Output Specification and Statement of Funds Available) helps insulate operations, maintenance and renewals expenditure from annual or in-year budget fluctuations. A stable planning and funding framework is an essential component of a predictable 'pipeline' of work that is necessary for an economic and efficient infrastructure industry. An independent body overseeing a multi-year settlement is the model that has a proven track record of securing steady investment in UK public utilities.

Example: Promoting the long-term sustainability of the network

An important area where ORR has found benefits in integrating safety and economic regulation concerns Network Rail's asset management. There is a close link between ensuring the network's assets are maintained safely and the performance of those assets.

ORR has consistently pushed Network Rail to improve its asset management capability by moving from a 'find and fix' approach to maintaining the railway to a 'predict and prevent' strategy. ORR undertook an extensive review of Network Rail's asset management policies as part of the 2013 price review and has continued to challenge Network Rail to do more to understand the reasons for asset deterioration and failure and to improve its asset information.

In response to concerns raised by ORR, Network Rail has been improving its asset management capability, and put in place a number of programmes including: Risk Based Maintenance, Intelligent Infrastructure and the ORBIS programme, which is helping Network Rail make better decisions about what, where, when and how to maintain and renew assets. ORR's regulatory targets require that ORBIS work streams are implemented on time, and that Network Rail achieves excellence in asset management by the time it submits its Strategic Business Plan for Control Period 6.

4. Evolving regulation

The DfT asked how the regulatory regime can be made most effective, with respect to issues including competition, protection of rail users, governance, accountability and efficiency.

Regulators need to reflect the changing realities of the industries they regulate, and the changing needs of customers in a way that provides long-term certainty to investors and funders. Regulation of the railway needs to reflect the structure of the industry so that it can address the particular market failures inherent in that structure, and to ensure that regulation is effective and does not itself create undue regulatory burden. The reclassification of Network Rail has changed its accountability to, and its financial relationship with, the Department for Transport. In consequence, reclassification has also changed the balance of regulatory incentives on Network Rail.

Network Rail now faces a binding limit on the debt it can incur, which significantly increases the pressure on its overall spending. This is a significant change to the company's financing environment from that in place when the Control Period 5 (CP5) settlement was agreed.

Following the Shaw Report's recommendations, government decisions on industry structure features – including ownership, financing and devolution – will mean ORR's approach to regulating Network Rail is likely to need to adapt. It may be necessary both to revisit aspects of the regulatory toolkit and to clarify roles and responsibilities in key areas.

i. A review of the regulatory toolkit following government decisions on industry ownership and structure.

- **Under a model of continued public sector ownership, it will be appropriate to consider a public sector regulatory toolkit.** A decision that part or all of Network Rail should continue to be fully publicly owned and financed may require ORR to develop alternative regulatory tools to reflect this, which draw on the experience of other regulators of public sector bodies. Regulation of quasi-commercial entities within the public sector is a relatively recent innovation in several sectors, where regulators rely on different powers and tools to create meaningful incentives for management teams to perform. Developing these tools for rail infrastructure would not alter the principles behind the need for effective regulation of the monopoly, as described above, or the balance of duties that ORR considered in performing its functions. The evolution of a 'public sector regulatory toolkit' would recognise the central reputational incentives facing management teams in the public sector in place of the greater focus on financial incentives in the private sector.
- **Under a model which introduces private capital, it will be appropriate to consider regulatory tools that align financial returns with performance.** If government decided to introduce alternative sources of capital on one or more routes, or to consider concession-based models of private delivery, this may create enhanced financial (in addition to reputational) incentives. ORR could

align returns on capital with performance. The concept of the Regulatory Asset Base (well established in a number of UK infrastructure sectors as a mechanism for giving investors confidence about future returns) is particularly relevant in this context. ORR already has experience of applying a regulatory framework that supports the investment of private capital into the HS1 concession, which may be relevant depending on the structures used. The existence of different approaches to financing and management in different routes would also improve the ability for ORR to use regional comparators to benchmark performance and hold other parts of the network to account (e.g. through separate licences).

- **If there is further formal separation/devolution of Network Rail's route-based businesses, clear separation of route based businesses brings the potential for sharper reputational incentives** making better use of information from benchmarking routes, as it would increasingly reflect the relative performance of local management teams. The trend towards regional devolution of funding decisions (including the possibility of greater roles for local transport authorities and devolved administrations) also means that funding decisions may increasingly require a more local regulatory approach with enhanced engagement between ORR and the governments and regions of the UK.

ii. Clarifying roles and responsibilities.

- **A Memorandum of Understanding between the government and regulator.** It would be helpful to clarify roles and relationships in light of the reclassification of Network Rail, and following decisions on industry structure. The BIS Principles for Economic Regulation (2011) state that "Government commits to ensure that responsibilities are clearly divided between Government and Regulator". Reclassification has highlighted the common and occasionally overlapping interest that the government and ORR have when overseeing Network Rail as shareholder and regulator respectively.

Given the mixed public and private interests in the railway, and the need to balance these interests fairly, it is important that the roles and relationship between the government and regulator are clear, that communication is transparent, and that actions taken by both are as predictable as possible within the scope of their responsibilities. With this objective, ORR considers that a Memorandum of Understanding between the government and regulator, based on the BIS principles of Better Regulation, may serve a useful purpose in describing respective roles, how engagement between the two will work, and establish for the comfort of the rest of the industry principles of transparency where common interests exist or roles overlap.

- **Clear responsibilities for planning and delivering enhancements.** The DfT has accepted the recommendations of the Bowe Review (October 2015) that it should take a more active role in overseeing the major enhancement projects that it specifies and pays for. The formal framework for enhancements planning, implementation and oversight will need to reflect any changes to the structure and funding of the industry implemented following the Shaw Review. Responsibilities for the planning and delivery of enhancements

will need to be clarified. ORR will consult later in 2016 about the processes and policies that will be followed by the industry and regulator to plan and deliver Control Period 6. In any approach, in the interests of efficiency and performance, enhancements should be considered alongside planned maintenance and renewals work where these could overlap. It also remains important that there are clear and transparent governance processes, likely to include:

- Prioritisation of strategic objectives in the early stages of project development.
 - Transparent criteria against which schemes can be prioritised and developed.
 - A change-control regime to allow flexibility to adjust programme outputs as required, with clear accountability.
- **Reviewing the arrangements to protect passengers and other users.** If the roles and responsibilities of different bodies across the industry are reset, it will be necessary to ensure that there is a clear, comprehensive and consistent approach to protecting rail users, supported by appropriate expertise. The Which? super-complaint raises a particular question about the respective functions of ORR and the DfT in safeguarding passenger interests under franchises. There may be value in clarifying the respective functions of DfT, ORR and Transport Focus, and considering issues such as the alternative use of franchise agreements or licence conditions to protect consumers.

Longer term structural reforms

In the longer term, there may be scope to introduce structural reforms that promote greater competition in the market. The 2015 Competition and Market's Authority (CMA) discussion document on rail competition explores the opportunities for more competition on the railways in the longer-term. This may also require further changes to the regulatory approach if markets were to become more competitive over time due to structural change, new investment or technological progress.

Regulatory options for PR18

ORR is already developing options to change the approach to regulation in the next Periodic Review (PR18), on which it will consult, including:

- **Options for route based regulation, setting outputs at route level and comparing performance.** As Network Rail devolves more management responsibility to routes, ORR is able to monitor and compare performance increasingly at the route level. ORR is developing new techniques – such as increased use of inter-route benchmarking – that have the potential to improve incentives for efficiency, as individuals and routes innovate and compete to increase the drive to improve performance.

- **The need to ensure the rail network operates more effectively as a system.** The network benefits (externalities) of an integrated rail system can be protected and enhanced by focusing on System Operation activities. The different and often conflicting pressures created by increasing demand for access to the network need to be expertly managed, to maximise capacity usage, keep costs down and deliver a high level of performance. ORR has been consulting⁴ on how to make this system operation of the network more effective to inform further engagement. ORR is looking at how Network Rail operates the rail network and how decisions by both Network Rail and others are made about the use of the network and its expansion over time. A discrete focus on Network Rail's system operation functions should help make better use of the network, benefiting both users and funders.
- **Reforming network charges, so that they better reflect the costs that users impose on the system and sharpen the incentives for Network Rail and its customers to reduce cost and make better use of the network.** The way in which Network Rail charges train operators for their use of its network affects decisions made by operators, Network Rail and funders. Charges do not currently closely reflect the costs of operating the infrastructure, with governments directly paying Network Rail for the majority through the Network Grant. In addition, many train operators have little incentive to respond to these charges as franchise agreements do not expose operators to changes in network charges. At times and places where the network is congested; this represents a missed opportunity to help operators and funders to improve how the network is used and to provide an additional stimulus to operators and Network Rail to reduce system-wide costs.

ORR will be publishing an initial consultation on PR18 in the spring.

⁴ [System operation – ORR consultation on making better use of the railway network, August 2015](#)

Annex: references

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

[BIS Principles for Economic Regulation, 2011](#)

[ORR website: what-and-how-we-regulate](#)

[ORR website: what-we-do/our-functions](#)

[System operation – ORR consultation on making better use of the railway network](#)

[Network Charges - ORR consultation on how charges can improve efficiency](#)

[ORR response to CMA consultation on competition in passenger rail services](#)

[ORR long term regulatory statement, 2013](#)

[Directive 2012/34/EU of the European Parliament and of the Council of 21 November 2012 establishing a single European railway area \(recast\)](#)

[Competition in passenger rail services in Great Britain, Competition and Markets Authority, July 2015](#)