



OFFICE OF RAIL REGULATION

Government, regulator, companies, customers: Status quo, challenges and two alternative models

RPI Conference

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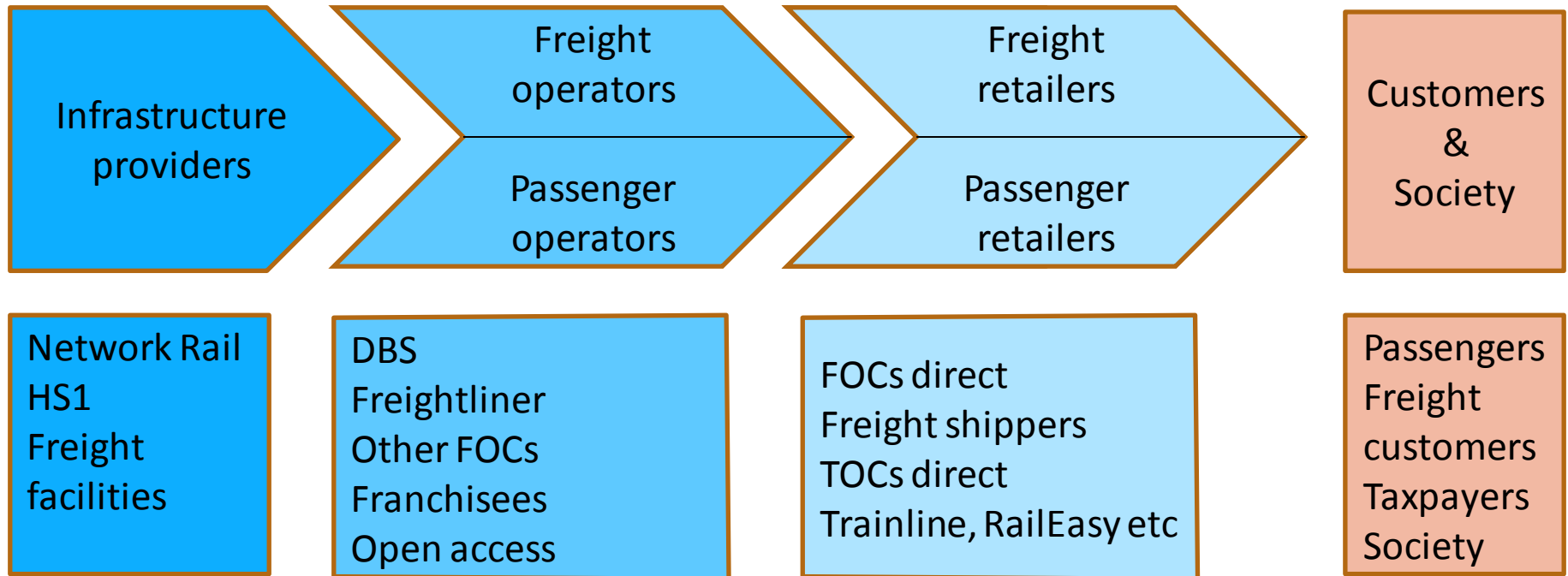
Overview

- Some definitions
- The status quo - what you might expect and what we have
 - The rail industry value chain
 - Network Rail's income
 - Rail industry flows of funds
- The role of government and its implications
- The current value for money challenge
- Two responses: tightening the screw vs 'normalisation'
- Points for discussion

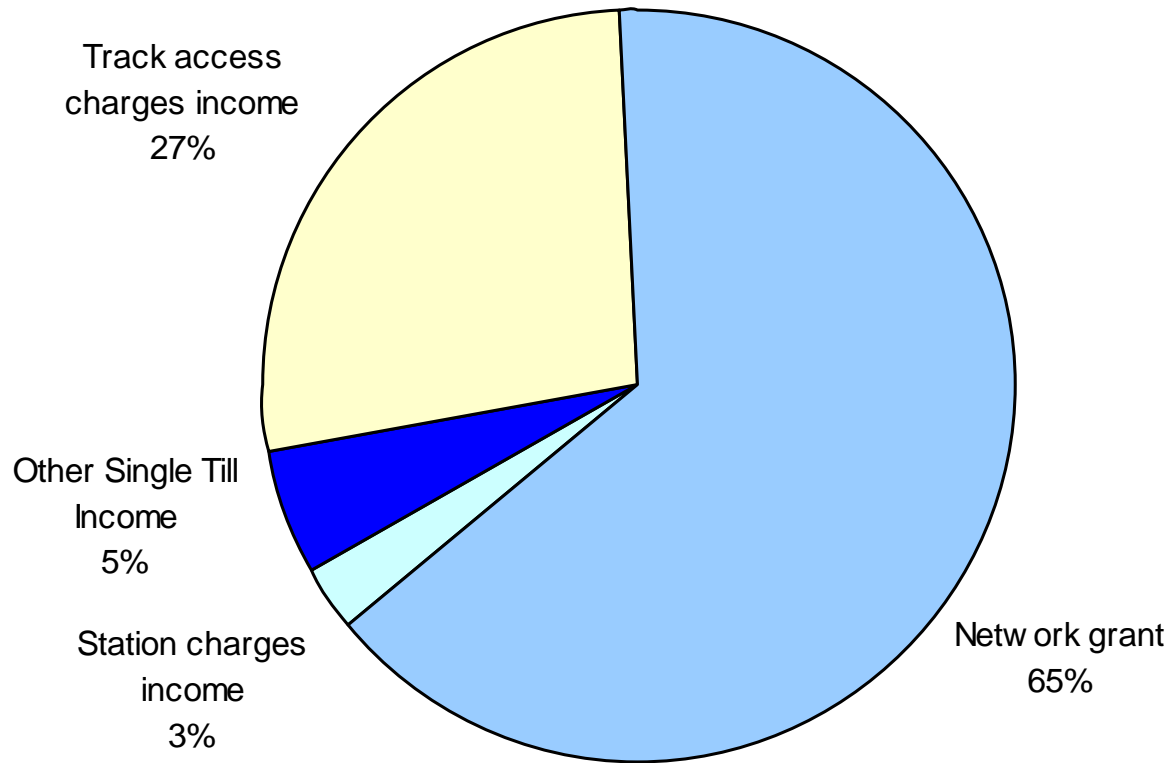
Consumer, customer, user, funder...

- 'Consumers' – exist at the end of the value chain, they consume the regulated service (often with other services), they pay for it and use it
- ... there are *current* consumers and *future* consumers
- 'Customers' – are those who buy the services provided by the regulated business, they can be an intermediate stages of the value chain
- 'Funders' – provide money to the regulated business, usually public sector organisations (central, local government, PTEs) on behalf of society

The rail industry value chain



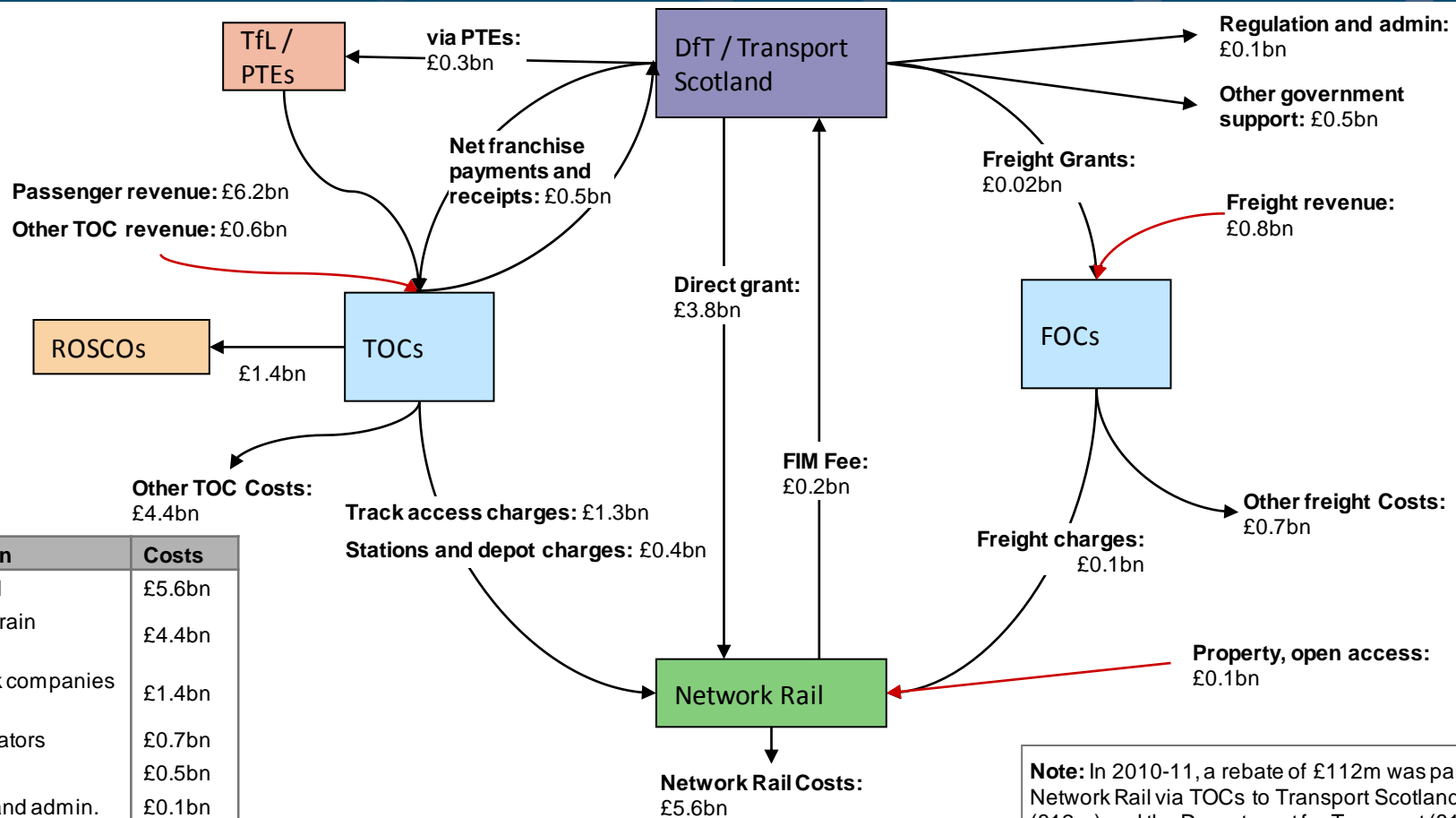
Total Network Rail income CP4



Estimated annual income in CP4 £5.5 billion (09-10 prices)



Rail industry funds flow– GB (2009-10 data)



Source: Value for Money Study and NR Annual Accounts

The role of government

- An extensive, multi-dimensional role
- **Legislation:** Sector-specific regulatory framework, general competition and consumer law
- Provider of **guidance** to the regulator: New guidance just received from UK and Scotland
- **Funder:** £4.2bn of funding into rail in 2010-11, 35% of total industry requirement
- **Customer:** Government specifies what it wants to buy from the railway every 5 years in its High Level Output Specification (and what it is willing to pay in the Statement of Funds Available)



Implications of government role - process

- Additional steps in the **process**:
 - Governments' **HLOS** and **SoFA** are a key input into a periodic review
 - In order to inform it we must produce '**advice to ministers**'
 - We need to ensure that HLOS is delivered for SoFA or go through '**mismatch**' process
 - These steps provide:
 - A way to avoid the regulator 'filling out the cheque for government to sign'
 - A high degree of certainty for the industry for each control period – avoiding the ups and downs of annual budgeting
 - The basis for close cooperation between regulator and government

Implications of government role - substance

- ▶ Differences in the **substance** of regulation:
 - ▶ Passengers and freight operators/customers are the '**residual funder**' :
 - ▶ Franchises and franchise competitions are designed to capture value for the taxpayer
 - ▶ Regulated fares are capped (by DfT) at a level designed to recover the cost of the railway not funded directly by government (or freight)
 - ▶ **Franchisee behaviour** is driven by their contracts with government – we cannot rely on them to behave as most customers of regulated businesses would
 - ▶ We are an independent regulator – this is critically important - but we have a **statutory duty** to have regard to the funds available to the SoS and Scottish Ministers

Implications of government role - accountability

➤ Additional **accountabilities**:

- Government is accountable for delivering value for large sums of taxpayers' money...
- ... drives government to tight **specification** of what they want to buy (in HLOS and franchise contracts)...
- ... and can lead to close government involvement in **monitoring** delivery (directly in franchises, relying on the regulator in infrastructure)

➤ This **risks**:

- Inefficiencies
 - Dampening of innovation
 - More powerful focus on government than on the consumer
- All highlighted by the recent McNulty Rail Value for Money Study -> less government involvement in detail seen as a key enabler of improved value for money



The value for money challenge response 1: 'turning the screw'

- ▶ The rail industry faces a critical value for money challenge:
 - ▶ Rail Value for Money study suggested *industry* costs could be £2.5bn-£3.5bn per year lower in 2018-19 than in 2009-10
- ▶ One response to this could be to increase pressure and tighten controls under the current framework:
 - ▶ More regulatory targets for Network Rail, more ambitious targets with less scope for outperformance
 - ▶ More scrutiny by us of (and regulation of?) inputs
 - ▶ Government keeps a tight grip on franchise specification and extraction of value for the taxpayer

The value for money challenge response 2: 'normalisation'

- ▶ An alternative response could be to change the framework:
 - ▶ Putting the rail industry on a more 'normal' footing...
 - ▶ Less *reliance* on public subsidy
 - ▶ More effective use of markets – including for passenger service provision
 - ▶ Government buying (with accountability for) what the market will not provide
 - ▶ A whole industry approach – including regulation
 - ▶ Better information for decision-making – including through charges



Implications of this choice

- The 'normalisation' model changes the interaction between regulator, government, companies, customers
 - Allows government to retreat from detailed specification and direct accountability without a loss of accountability overall
 - More accountability of companies to their customers (and to regulators on behalf of customers where necessary)
 - ... important in allowing delivery of greater efficiencies and innovation
- But it is not an easy choice:
 - It is not a quick win
 - It relies on fundamental changes e.g. to charges, to franchises (new ones are c. 15 years long)
 - And requires political confidence in different mechanisms for delivery and accountability

What can/should ORR do?

- ▶ The choice of the model of passenger service provision is a major influence on the industry...
- ▶ ... and is a choice for government
- ▶ We are taking steps that are consistent with a different approach...
- ▶ ... and that will facilitate different choices:
 - ▶ Transparency
 - ▶ Charges
 - ▶ System operation
 - ▶ A more whole industry approach – performance and cost
 - ▶ A more passenger-facing role



Some points for discussion

- ▶ How feasible is the 'normalisation' model given the amount of public money going into rail?
- ▶ What are the critical success factors for a change in approach?
- ▶ How can we ensure legitimate and appropriate accountability?
- ▶ What transition issues will arise and how should they be dealt with?
- ▶ What are the lessons from other sectors?