House of Commons
Committee of Public Accounts

Network Rail: making a fresh start

Twenty-eighth Report of Session 2004–05

Report, together with formal minutes, oral and written evidence

Ordered by The House of Commons to be printed 6 April 2005
The Committee of Public Accounts

The Committee of Public Accounts is appointed by the House of Commons to examine “the accounts showing the appropriation of the sums granted by Parliament to meet the public expenditure, and of such other accounts laid before Parliament as the committee may think fit” (Standing Order No 148).

Membership

Mr Edward Leigh MP (Conservative, Gainsborough) (Chairman)
Mr Richard Allan MP (Liberal Democrat, Sheffield Hallam)
Mr Richard Bacon MP (Conservative, South Norfolk)
Mrs Angela Browning MP (Conservative, Tiverton and Honiton)
Jon Cruddas MP (Labour, Dagenham)
Rt Hon David Curry MP (Conservative, Skipton and Ripon)
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Rt Hon Frank Field MP (Labour, Birkenhead)
Mr Brian Jenkins MP (Labour, Tamworth)
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Mr Stephen Timms MP (Labour, East Ham)
Jon Trickett MP (Labour, Hemsworth)
Rt Hon Alan Williams MP (Labour, Swansea West)

The following was also a member of the Committee during the period of this inquiry.

Ms Ruth Kelly MP (Labour, Bolton West)

Powers

Powers of the Committee of Public Accounts are set out in House of Commons Standing Orders, principally in SO No 148. These are available on the Internet via www.parliament.uk.

Publications

The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the Internet at http://www.parliament.uk/pac. A list of Reports of the Committee in the present Session is at the back of this volume.

Committee staff

The current staff of the Committee is Nick Wright (Clerk), Christine Randall (Committee Assistant), Ronnie Jefferson (Secretary), and Luke Robinson (Media Officer).

Contacts

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Summary

The Department for Transport (the Department) established Network Rail in March 2002 to bid for Railtrack’s network business. Network Rail was the only bidder and acquired the business in October 2002. In January 2004, dissatisfied with rail industry performance, the Department announced a review.

Network Rail’s corporate governance and accountability were complex. It was a Company Limited by Guarantee with members from different interest groups instead of shareholders. It was also a regulated monopoly, financed by private sector debt made available in part because of indirect support from the Strategic Rail Authority (SRA).

The SRA’s formal powers were not commensurate with its responsibilities. In particular it had no clear rights to set strategy, specify spending priorities or intervene at an early stage if Network Rail’s finances veered off course.

Network Rail had made a start in improving the operational performance of the network and cost control, both of which deteriorated following the Hatfield derailment in October 2000. Punctuality had improved but was forecast to remain below October 2000 levels until 2008–09. Spending was expected to stabilise some 30% above pre-Hatfield levels. There were no longer term financial targets against which to measure performance.

Network Rail was being funded through a mix of short and medium term debt from banks and the commercial paper market, costing some £25 million to £30 million more than public sector funding. There were concerns in case this cost was being incurred to keep the debt off the Government’s books. Network Rail had plans to raise long term debt secured against future revenues but had not yet met the conditions necessary for raising such debt. The long-term cost could not, therefore, be fixed or compared to Government guaranteed debt.

In July 2004, the Government published a White Paper\(^1\) on the future of the industry, which proposed an expanded role for the Department and Network Rail, and the winding up of the SRA. Network Rail is to be accountable for industry performance under a binding agreement with Government. The agreement would include performance targets proposed by the Department, then negotiated with the relevant parties and monitored by the Office of Rail Regulation (ORR).

The Department plans to decide on total rail spending and priorities through a series of iterative consultations with stakeholders including regional/local interests.

Direct Government support for Network Rail’s long term debt programme was announced to reduce borrowing costs, leading to savings that could reach £190 million per year.

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\(^1\) Cm 6233, The Future of Rail
It remains to be seen how effectively Network Rail will be able to bear its responsibility for overall industry performance given that the Department determines the shape of the network and sets the terms and conditions of the franchises awarded to train operating companies.

Network Rail can borrow up to £21 billion, now backed directly by the Government, leading to interest cost savings over previous plans. The Department needs to put arrangements in place to manage the risks of such Government support effectively.

On the basis of a Report by the Comptroller and Auditor General,2 we took evidence from the Department of Transport and the Strategic Rail Authority on the establishment of Network Rail in place of Railtrack and the subsequent review of the Rail industry. In this Report we consider the issues raised by the C&AG’s Report and in evidence to this Committee; how far those issues have been met by the subsequent White Paper proposals; and what remains to be done.

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2 C&AG’s Report, Network Rail – Making a fresh start (HC 532, Session 2003–04)
Conclusions and recommendations

1. The Department will need to set strategy more effectively than did the SRA. The SRA was over reliant on Network Rail’s own commitment to strategic goals, but Network Rail remains in a strong position to pursue its own agenda.

2. In taking on its new responsibilities, following the abolition of the SRA, the Department should recruit enough staff with commercial and technical skills and with the stature necessary to deal effectively at the highest levels of the railway industry. The new framework will not be likely to lead to improvements if the Department treats this new function as a routine civil service task.

3. Network Rail should develop long term financial indicators to help judge whether it is meeting its performance objectives in a cost effective way over time. These should help Network Rail manage the cost of track maintenance and renewal over time, after taking account of the number of passenger miles undertaken. Adjusted for differences such as the age of the network, such measures would also facilitate regional and international comparisons.

4. As the Department ultimately stands behind Network Rail’s financial liabilities, it should establish effective oversight of the risks. The Department cannot rely on regulatory oversight to protect its financial risk, as the Office of Rail Regulation (ORR) has to balance a wide range of interests. The Department for Trade and Industry has a similar responsibility for the risks to the taxpayer arising out of British Energy’s financial performance. The DTI’s Shareholder Executive is predominantly staffed for that function by experts with an investment background, separate from the civil service teams that deal with policy and regulatory matters. There could be advantages in following a similar model in this case.

5. The Government should justify explicitly the extra cost of private finance rather than conventional public funding of Network Rail. The new arrangements are less costly than the company’s previous plans because they now benefit from direct Government support. They are still more expensive than direct public sector financing. It is not clear how private sector lenders can provide the necessary discipline on the company to offset the extra cost of private finance.
1 Corporate governance and accountability

1. After Railtrack went into administration in October 2001, the Department for Transport (the Department) established Network Rail to bid for Railtrack’s network business. It was established in March 2002 as a Company Limited by Guarantee, which pays no dividends and finances its activities through retained surpluses and borrowing. It was the only bidder and acquired Railtrack’s business in October 2002.

2. As a regulated monopoly and a Company Limited by Guarantee Network Rail is directly accountable to its 114 members, the Office of Rail Regulation (ORR) and customers. The strategic importance of the rail industry and the need for Government support for Network Rail’s financing meant that the Department also had a legitimate interest in Network Rail’s performance.

3. The Department and the SRA agreed that the accountability structure was not satisfactory. A structural weakness was that to achieve its strategic priorities the SRA needed Network Rail’s own commitment to those priorities, though the SRA emphasised that Network Rail’s co-operation was not just voluntary. The Department believed itself to be capable of giving strategic leadership to the industry, and the SRA saw advantage in having only one party specifying the outputs for the railway to deliver in the public interest.

4. The July 2004 White Paper proposed a new structure (Figures 1(a) and 1(b)).

Key changes were:

i. the Department taking control of strategy from the SRA; and

ii. Network Rail being given accountability under a new and binding arrangement with Government for the performance of the network, and for co-ordinating the industry’s planning.

5. Under the new structure the Department has responsibility for deciding on key rail outputs including the overall size and shape of the network, minimum performance targets and the award of new rail franchises. Network Rail is to take on responsibility for making the new operational management and planning arrangements work, including:

- drawing up route utilisation strategies for agreement by the Department;
- devising timetables based on those route strategies and input from train companies;
- directing network operations and recovery of services following incidents and delays;

3 C&AG’s Report, Executive Summary, para 3
4 Qq 9, 20–27, 60–68, 81–83, 166
5 White Paper, The Future of Rail (Cm 6233, July 2004), paras 4.3.10–4.3.11
- devising and delivering infrastructure maintenance and renewals, as well as delivering enhancements to the network as appropriate; and
- accounting publicly for performance.\(^6\)

6. Winding up the SRA and expanding the role of the Department are intended to lead to a simpler, more effective industry structure. These changes also increase the responsibility and demands on Network Rail. As under the previous system, the role of the ORR is crucial to the effectiveness of the accountability arrangements. Under the new system the Department proposes its required outputs to Network Rail, which shows how it intends to meet them and at what cost. Following agreement to a particular strategy, and taking the requirements of all customers and funders into account, ORR would consider giving the strategy force under the regulatory regime in the form of “a statement of reasonable requirements”.\(^7\)

7. The White Paper recognised that the Department would require new areas of technical and professional expertise and said the Department would be properly staffed to carry out its new role. Many existing SRA staff are likely to move to the Department. The number, skills and experience of staff taken on by the Department will have an important impact on the success of the new arrangements.\(^8\)

\(^6\) White Paper, The Future of Rail (Cm 6233, July 2004), paras 4.3.6, 4.3.11
\(^7\) Qq 9, 62; White Paper, para 3.1.7
\(^8\) White Paper, The Future of Rail (Cm 6233, July 2004), paras 4.3.6, 4.5.2
Figures 1(a) and 1(b) show the new and old structures.

Figure 1 a): The structure proposed by the White Paper

![Diagram of new structure]

Department for Transport

Agree route utilisation strategy

Arrangements covering what NR will deliver for the price set by the ORR

Franchise Agreements

Network Rail

Responsible for operating the network under licence from ORR (1)

Joint working at local level

Train Companies

Network Rail Routes

Rail Passengers

(1) For simplification purposes the regulatory regime is not depicted here.

Source: White Paper, Figure accompanying para 4.3.1, and the National Audit Office

Figure 1 b): The previous structure

![Diagram of old structure]

Department for Transport

Statutory guidance and direction

Strategic Rail Authority

Non Departmental Public Body

Cooperation and other agreements

Special membership rights

Franchise Agreements

Network Rail

Responsible for operating the network under licence from ORR (1)

Access agreements and network code

Train Companies

Network Rail Routes

Rail Passengers

(1) For simplification purposes the regulatory regime is not depicted here.

Source: C&AG’s Report (HC 532) Figure 1, presented to be consistent with the preceding figure
2 Operating performance and cost control

8. Immediate challenges for Network Rail had been to improve performance and cost control. Punctuality is usually taken as the main measure of performance (Figure 2). Network Rail’s punctuality performance is measured by the number of delay minutes incurred, peaking at 14.7 million minutes of delays in 2002–03. Annual infrastructure costs had risen steeply and were expected to peak in 2003–04 at £6 billion. At £4 billion in 2008–09, the end of the current regulatory settlement, they were projected to remain 30% higher than before the Hatfield derailment of October 2000.9

9. Network Rail succeeded in improving punctuality but projected that it would remain below the levels that preceded the Hatfield accident until 2008–09. Delay minutes attributable to Network Rail were planned to fall by 43% to 8.4 million by 2012–13, helping the industry towards a punctuality target of 91.4%.10 Network Rail considered this long term target to be meaningful despite annual revisions to targets.11

Figure 2: Percentage of trains arriving on time

Source: C&AG’s Report, Network Rail–Making a Fresh Start (HC 532, Session 2003–04) updated from National Rail Trends, published by the Strategic Rail Authority

10. Other performance improvements, such as faster services and better stations, also needed to be a Network Rail priority. Demand for rail services was increasing but unevenly. Certain parts of the network, such as Thameslink Services, had experienced demand growth of up to 70%, whereas rural areas had experienced much less growth.12

9 C&AG’s Report, paras 2.3, 2.5
10 Qq 69–73
11 Qq 73–78
12 Qq 87, 90, 105
11. As Network Rail’s knowledge of the condition of railway assets improved, it found more assets coming to the end of their useful life or needing attention for safety reasons. Network Rail’s resulting infrastructure spending projections exceeded pre-Hatfield levels, despite measures to control costs.  

The level of spending which an efficient Network Rail would be allowed to operate, maintain and renew the rail infrastructure is determined by the regulatory regime. A regulatory review completed in December 2003 had concluded that spending of £22.2 billion over the five years to 31 March 2009 would be needed. An additional £2.4 billion for enhancements had also been allowed.

12. In practice Network Rail has some freedom to spend more or less than the regulatory settlement provides, depending on its commercial judgement and its ability to borrow. Figure 3 shows that Network Rail plans to increase total expenditure on the operation, maintenance and renewal of the network to £23.3 billion over the five years, mainly due to additional planned spending on signalling renewals. Completion of work on the West Coast Main Line accounts for most of the projected decline.

Figure 3: Trends in planned Network Rail spending

13. The need for increased spending compared to pre-Hatfield levels is attributed, in part, to underinvestment in the earlier period. Railtrack had seen itself as the owner of assets which others maintained, so that decisions on the amount and timing of maintenance work were made by maintenance contractors. Railtrack paid for contractors’ assessment of the work required. Network Rail decided what maintenance should be done and when and had secured both cost savings and improvements in performance.

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13 C&AG’s Report, para 2.1; Qq 6, 98
14 Qq 5, 79
15 Qq 10, 12, 98, 142
14. Network Rail’s cost control measures included:

- bringing maintenance in-house to control quality and costs, with initial savings of £70 million per year;
- putting in place a series of renewals contracts at a lower unit cost than in the past, with targets to reduce the renewals cost further;
- reducing management numbers by a target of 2000 over two years, including 600 middle managers in 2003–04; and
- offering apprenticeships for new railway workers, increasing graduate intake, and taking engineers from other disciplines on to conversion courses for track or signalling.16

15. Under a Management Incentive Plan, top management can receive bonuses of up to 60% of salary. The principles behind the plan had been agreed by the SRA but were now mainly the responsibility of Network Rail’s Remuneration Committee, composed of non-executive Directors. The Remuneration Committee takes independent advice as to the terms needed to attract the right level of skills and expertise.17 One-third of the bonus payable under the Management Incentive Plan is set by reference to a financial efficiency index, which compares spending to budget but without taking unit costs into account. Network Rail has agreed with ORR that it will be examining the appropriateness of this measure for the 2005–06 Management Incentive Plan and the two bodies are working towards developing a more robust measure.18

16. For the future, the Department plans to decide on total rail spending and priorities through a series of iterative consultations with stakeholders, including regional/local interests. The aim is to introduce greater dialogue over route priorities both at the strategic and the local level. The Department intends to involve the devolved regions and passenger train executives in decisions on the best use of subsidy, comparing different modes of transport.19

17. The Department and Network Rail saw possible benefits in developing a longer term financial target for Network Rail. This would measure the cost of track maintenance and renewal over time, adjusting for the number of passenger miles undertaken. Such measures are used in many other industries and rail businesses overseas. Targets would be regularly reviewed and could be benchmarked against what others had achieved, adjusting for differences such as the age of the network.20

16 Qq 6, 10–14
17 Qq 3, 33–36
18 ORR Consultation for a balanced scorecard for Network Rail, November 2004
19 White Paper, The Future of Rail (Cm 6233, July 2004), paras 2.5.16, 4.3.6 and Chapter 5
20 Qq 4, 150–151
3 Financial resources and risk

18. Most of Network Rail’s income comes from track access charges paid by train operating companies totalling around £1,900 million in 2003–04. It also receives direct government grants towards the cost of maintaining and renewing the network, of some £452 million in 2003–04. The December 2003 regulatory settlement for the 5 years to 2008–09 was intended to put Network Rail’s finances on a stable footing that could accommodate substantially increased debt. Borrowing, some £6,300 before Railtrack’s acquisition by Network Rail, had increased to £9,190 million by March 2003 and to £14,262 million by September 2004,\(^\text{21}\), reflecting increased spending after the Hatfield derailment, and £1,875 million of revenue shortfalls (Figure 4). In addition it was agreed that track access charges would not be increased for the first two years of the five year regulatory settlement. The shortfall was to be made up by grants and increased borrowing of over £3 billion.

Figure 4: The increase in Network Rail’s borrowing

19. After the regulatory settlement Network Rail had intended to go to the markets, backed by an expectation that the regulatory review would have given the markets confidence to invest in a form of bond issue secured against future revenues.\(^\text{22}\) In the interim Network Rail met its financing requirements through short term borrowing facilities from banks and the commercial paper market, with support from the SRA. This form of borrowing resulted in extra annual costs of £25 million to £30 million, compared to short term public

\(^{21}\) Unaudited financial statements for six months ended 30 September 2004.

\(^{22}\) Q 68
sector borrowing rates. There were concerns in case this cost was being incurred to keep the debt off the Government’s books. This cost was defended on the basis that Network Rail benefited from being classified as a private sector company.\textsuperscript{23} Figure 5 sets out Network Rail’s finance arrangements at April 2004.

**Figure 5: Network Rail finance arrangements at April 2004**

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<th>Facility</th>
<th>Total available (£ billion)</th>
<th>Amount drawn at April 2004 (£ billion)</th>
</tr>
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<tr>
<td>Bridge facility \textsuperscript{†}</td>
<td>5.50</td>
<td>1.25</td>
</tr>
<tr>
<td>European Investment Bank and Kreditanstalt für Wiederaufbau (KfW)</td>
<td>1.05</td>
<td>1.05</td>
</tr>
<tr>
<td>Medium Term Loan Notes</td>
<td>6.50</td>
<td>6.50</td>
</tr>
<tr>
<td>Commercial Paper Programme</td>
<td>4.00</td>
<td>4.00</td>
</tr>
<tr>
<td>‘Opco’ facility Tranche A\textsuperscript{††}</td>
<td>4.00</td>
<td>0.00</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>21.05</strong></td>
<td><strong>12.80</strong></td>
</tr>
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</table>

*Source: Strategic Rail Authority*

**Key**

\textsuperscript{†} Banking facility, backed by the SRA, to help fund Network Rail’s acquisition of Railtrack and to provide short-term working capital

\textsuperscript{††} This facility is designed to act as substitute equity and has an expiry date of 2052

20. Network Rail and the Government subsequently decided not to incur the potentially larger extra borrowing costs that would be involved in a bond issue secured on revenue. Such extra costs would not have been accompanied by substantial risk transfer.\textsuperscript{24} The financing structure adopted instead envisages a mix of ten and twenty year bonds (or other forms of debt) supported by a direct, irrevocable financial indemnity from a crown body. The bonds have been rated AAA, which is the highest credit rating, compared to a lower BBB rating for the structure previously contemplated. ORR calculated that if Network Rail had gone ahead with raising £20 billion of debt through the bond structure previously envisaged, the extra cost would have been £190 million per year.\textsuperscript{25}

21. In the case of the Channel Tunnel Rail Link, private sector debt was given a Government guarantee part way through the construction. At the outset of that project private shareholder funds had been committed and to some extent remained at risk. In the case of Network Rail private financial discipline is absent because all providers of funds are fully indemnified against any shortfall in debt service for any reason. As our predecessors’ Report on the Channel Tunnel Rail Link showed, there are extra costs of the public sector

\textsuperscript{23} Qq 7, 8; C&AG’s Report, para 3.15

\textsuperscript{24} C&AG’s Report, paras 3.18–3.23

\textsuperscript{25} ORR Statement, *Network Rail’s Long Term Debt Issuance Programme*, October 2004
guaranteeing private sector finance compared to financing through a Government bond issue.  

22. The Department’s credit exposure to Network Rail will be ongoing and will need vigilant monitoring, using specialist expertise. ORR, which has to balance all parties’ legitimate interests, not just the residual risk of the taxpayer, is not appropriately placed to monitor this risk. In the case of British Energy, the Department of Trade and Industry monitor this risk explicitly, and separately from policy related issues, through the Shareholder Executive.  

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Formal minutes

Wednesday 6 April 2005

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Allan  Mr Ian Davidson
Mrs Angela Browning  Mr Alan Williams

The Committee deliberated.

Draft Report (Network Rail: making a fresh start), proposed by the Chairman, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 22 read and agreed to.

Conclusions and recommendations read, amended and agreed to.

Summary read and agreed to.

Resolved, That the Report be the Twenty-eighth Report of the Committee to the House.

Ordered, That the Chairman do make the Report to the House.

Ordered, That the provisions of Standing Order No. 134 (Select Committees (Reports)) be applied to the Report.

[Adjourned.]
Witnesses

Wednesday 26 May 2004

Mr David Rowlands CB, Department for Transport, Mr Richard Bowker, Strategic Rail Authority, Mr John Armitt CBE, and Mr Ian McAllister CBE, Network Rail

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Oral evidence

Taken before the Committee of Public Accounts

on Wednesday 26 May 2004

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Allan
Mr Richard Bacon
Mrs Angela Browning
Jon Cruddas
Mr David Curry

Mr Brian Jenkins
Mr Gerry Steinberg
Jon Trickett
Mr Alan Williams

Mr Tim Burr, Deputy Comptroller & Auditor General, Mr Jeremy Colman, Assistant Auditor General, and Ms Patricia Leahy, National Audit Office, further examined.

Mr Rob Molan, Secondary Treasury Officer of Accounts, HM Treasury, further examined.

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL:

Network Rail—Making a Fresh Start (HC 532)

Witnesses: Mr David Rowlands CB, Permanent Secretary, Department for Transport; Mr Richard Bowker, Chairman and Chief Executive, Strategic Rail Authority; Mr Ian McAllister CBE, Chairman, and Mr John Armitt CBE, Chief Executive, Network Rail, examined.

Q1 Chairman: Good afternoon, and welcome to the Committee of Public Accounts where today we are considering the Comptroller & Auditor General’s Report on Network Rail which obviously operates and maintains our national rail infrastructure. We are very pleased to welcome to our Committee a distinguished band of people who run our national railways; thank you for coming today. We have Mr David Rowlands, who is accounting officer for the Department for Transport, and has been to our Committee before; Mr Richard Bowker, who has also been before, is Chief Executive of the Strategic Rail Authority, and we are grateful also to Mr John Armitt, the Chief Executive Officer of Network Rail, and his Chairman, Mr Ian McAllister, who is attending today. You are all very welcome. Could I start, please, by asking the National Audit Office a question? There was a report in the Daily Telegraph on Friday May 14 which said that, “The National Audit Office, to its discomfort, has to justify why it has watered down a hard hitting draft report of Network Rail under government pressure”. Is there any truth in this?

Mr Burr: We do not regard ourselves as having watered it down at all.

Q2 Chairman: Are there any significant changes at all in this Report which we have before us compared to any draft report?

Mr Burr: Inevitably in the process of drafting the draft evolves, and this was no exception, but not because it was being diluted.

Q3 Chairman: Thank you. Mr Rowlands, could I please ask you to look at page 20, paragraph 2.31? It says there that Network Rail management sets its own incentive plan. How can you be sure that you are involved in this and you have a say, given that you bear the equity risk for this business?

Mr Rowlands: We, the Department, are not involved in it. It is the Regulator, as a condition of the Network Rail licence, that in a sense polices the management incentive plan going forward within the framework of the ground rules for the plan as originally set out when Network Rail was created, but we do not have a direct involvement in the plan.

Q4 Chairman: Could I please ask you to look at question? There was a report in the Daily Telegraph pages 21 and 22, paragraphs 2.35 and 2.36? You will see in 2.35 that Deutsche Bahn, the German railway, which is so highly thought of that its trains figure on the front of the Report, which operates the German network has a target of reducing its price per train per seat kilometre. Why do you not think that equally meaningful targets should be developed for this business?

Mr Rowlands: We, the Department, are not involved in it. It is the Regulator, as a condition of the Network Rail licence, that in a sense polices the management incentive plan going forward within the framework of the ground rules for the plan as originally set out when Network Rail was created, but we do not have a direct involvement in the plan. We, through the Strategic Rail Authority, originally had early involvement as Network Rail was being set up but, once it was in place, as I say, the interest passed to the Regulator through the network licence.
can measure you can manage and, in a sense, anything you can measure you can also manipulate if you are not careful, and this particular indicator could be manipulated. You can reduce apparent costs per train kilometre by cutting back on maintenance and renewal expenditure to the long term detriment of the system so it needs some careful thought but yes, in principle, I can see the long term advantage of this as a long term indicator.

Q5 Chairman: Thank you. Mr Bowker, could you look at paragraph 3.16 on page 29, where you will see that in aggregate the support from the Strategic Rail Authority totals £21,000 million. How can you be sure that we are not throwing good money after bad, as was the case with Railtrack?

Mr Bowker: There are a number of reasons. The £21 billion is broken down into a number of very specific support packages relating to different things, and we knew at the time we created Network Rail the justification for each of those. The other very important reason is that, since the creation of Network Rail, the Rail Regulator has carried out an access charges review and has determined the amount of income that he believes Network Rail needs to deliver the reasonable requirements of its customers, and is content that that represents the efficient and economic price, and the support packages that we have in place reflect Network Rail’s ability to deliver against that efficient and economic price.

Q6 Chairman: Mr Armitt, could I please ask you to look at paragraph 2.5 on page 15, where you will see that “Network Rail’s business will contain this trend, but will still leave expenditure some 30% above pre-Hatfield levels”. How do you think the costs could be better controlled?

Mr Armitt: We are putting in place a whole series of actions to control cost. We have recently bought maintenance in-house; we are confident that that will result in cost reductions. We have only just finished placing a series of renewals contracts, which have been put in place at a lower unit cost than has been the case in the past and there are targets within them to further reduce the renewals cost. We have also got a programme which has started and which will continue to ensure we only have the right number of people in the organisation to do what we have to do. We have recently put in place a programme to reduce total staffing levels; we reduced by 600 last year and we plan to continue that to 2000 over the next couple of years, so there are a whole series of initiatives which will enable us to reduce costs.

Q7 Chairman: Thank you. Mr McAllister, could I please ask you to look at paragraph 3.15, page 29? You will see there that Network Rail’s borrowing cost £20–35 million more than public sector borrowing. What benefit are you getting from this extra cost?

Mr McAllister: I think the benefit that the government gets is that we are operating as a private not-for-dividend company, and that enables us to take decisions without reference to government, and I think the efficiency of those decisions and the speed of action that we can take is well worth the amount invested.

Q8 Chairman: Mr Rowlands, is this a device to keep this off public borrowing?

Mr Rowlands: No, it is not, though it has the consequence that it keeps it off public borrowing. As a matter of policy, the government wanted the successor to Railtrack when it came out of administration to be a private sector company for the sorts of reasons that Mr McAllister alludes to. It was not driven by a notion that we wanted to keep this off the public sector balance sheet; it was driven by a policy decision that what was wanted was a private sector company because of the benefits that would flow of the kind Mr McAllister has alluded to.

Q9 Chairman: Mr Bowker, lastly, could you please look at paragraph 3.4 which you will find on page 25? It says that the SRA is best placed to assess the long term size and skill of the national railway network. How can you achieve your aims if you rely so heavily on Network Rail’s voluntary commitment to your aims?

Mr Bowker: I am not sure I would accept that Network Rail’s commitment is voluntary. It is important because the Strategic Rail Authority, as the railway industry is currently structured, is not the only participant in the rail industry; there are third party commercial parties, for example, freight operators who use the network quite independent of our support, so it is important that Network Rail is responsive to its customers’ requirements. We have a major role in determining what they are, and the Regulator has a statutory duty to take our strategies and budget into account which he does, and once he has determined what Network Rail should do then it is not a voluntary act as to whether it does it.

Q10 Jon Cruddas: Can I ask a couple of questions about what has happened since October 2003 when it was announced that they were in the process of bringing in 100% maintenance work? Reading the Report, I could not quite pull out the specific reasons why that was. Mr Armitt, could you just explain why? You mentioned cost earlier but there are others issues here about staff morale, lack of planning, the fragmentation of it and possibly safety issues, so could you rehearse the reasons from your view?

Mr Armitt: The fundamental weakness as we saw it with the maintenance activities was that the amount of work which should be done and the decisions about when it should be done were fundamentally made by the maintenance contractors, and Railtrack then essentially paid the bill for what contractors were determining were the most appropriate outputs. We felt that was wrong. We felt we should be the people who decided what should be done to the network in terms of maintenance and when it should be done, and with far more control of the activity, and therefore we wanted far more control of the costs. It gave us more opportunity to ensure that the quality was absolutely what we wanted because
Chairman: You will have to speak up, please, because the acoustics are not very good in this room.

Q11 Jon Cruddas: That was announced in October 2003. Reading and Wessex were brought in-house in November 2003. Could you remind us of the timescale for the total completion of the project?

Mr Armitt: So far we have brought in Reading, Wessex, and the East Midlands, we have bought in the three areas which were covered by Jarvis, and we are on programme to complete all maintenance coming in-house by the end of July of this year.

Q12 Jon Cruddas: On your assumptions about being able to pull in cost, what is your experience to date of pulling that in?

Mr Armitt: I think the principal benefit we have seen so far is a disproportionate improvement in performance of the railway where we have bought maintenance in-house. Performance has improved better than the average particularly in the Thames Valley and the Wessex area. In terms of costs, undoubtedly we are now getting a much better understanding of the requirements and we are having more direct control of the activities which take place, which inevitably leads to more control of cost.

Q13 Jon Cruddas: And is it possible that you can quantify the anticipated savings involved in the total programme?

Mr Armitt: We believe the initial quantification of savings is going to be in the region of £70 million per annum, but we are looking for a lot more than that in the longer term.

Q14 Jon Cruddas: Following on from that, I notice in paragraph 2.22, the second bullet point, the Report states, “the privatised industry has tended to rely on the development of skills and expertise through experience rather than structured training”. Again, could you detail what sort of structured training programmes you are putting in in terms of that, and is that a reflection of problems you had in terms of the quality of labour in the Railtrack regime?

Mr Armitt: Starting with the sharp end, if you like, one of the things we are going to do and have started work on is to ensure that everybody coming into the industry, particularly at the younger end of the scale, is offered the opportunity of an apprenticeship, so we intend to have an apprenticeship scheme for railway workers coming into our company. In the meantime we have been putting in place some short term programmes, for example, for engineers. We have been taking engineers from other disciplines and operating a conversion course which takes, for example, a highways engineer and at the end of a few months he is able to come out on the railway with some basic engineering skills for permanent way, and, indeed, a second course for signalling engineers. We have also increased our graduate intake going forward, and we also expect to do more, going forward, job swaps, if you like, between ourselves and the train operators, for example, to get a cross-flow of skills between ourselves and the train operating companies.

Q15 Jon Cruddas: Because one of the issues that comes out of this is the issue around staff morale.

Mr Armitt: Training is absolutely essential to staff morale.

Q16 Jon Cruddas: That is why I ask the question because the Q12 surveys and the like still show a real problem even though evidence suggests that recently that might have been improving. Presumably you put that down to some of the changes in employment conditions within the industry?

Mr Armitt: Yes. What was encouraging about Q12 is we carried it out for the second time at the same time as we were putting in place 600 redundancies, so you would almost expect a negative response, but in fact we got a more positive response which meant we had undoubtedly moved in the right direction. Q12 relies on a whole series of action plans and follow-ups to the consequences of the survey, and the important thing is we are following those through and we intend to continue to think of Q12 as a fundamental part of our culture and training and our approach to the company every year. We will have a result every year.

Q17 Jon Cruddas: Lastly, relating to figure 8 on page 21, the Key Performance Indicators in Network Rail’s 2003–04 Management Incentive Plan. As I see it, as stated in paragraph 2.32 and figure 8b, the targets in terms of ASI, which are a weighted average of a number of indicators, signal failures, broken rails, instances of poor track geometry and the like, for 2003–04 in paragraph 8b is less than the target for 2002–03. Does that signal a reduction in the targets for this number of indicators themselves?

Mr McAllister: Is this the drop from 0.96 to 0.92?

Q18 Jon Cruddas: No. It is the drop in terms of targets to 0.96 from 1.03.

Mr McAllister: That is getting better.

Mr Armitt: That is turning the right way, because if you look at the enhanced target it is 0.92 compared with 0.96, so a reducing number is an improvement in the situation.

Jon Cruddas: Thank you. That was my misreading of the situation.

Q19 Mrs Browning: Mr Rowlands, you are quoted, or the Department is, in paragraph 1.15, page 9, as saying, “Relationships within the industry were viewed by the Department and Mercer as poor”. What do you think needs to be done to improve that?

Mr Rowlands: This is a piece of work that Mercer’s did at the point where Railtrack had gone into administration so it is a snapshot of what the world looked like, we would say, 18 months to two years ago. There was no doubt that, both from the work that Mercer’s did and, indeed, from the view the
Department took, relations were not as good as they should have been. Certainly I do not think there was much dispute; there was a difficult relationship between the train operating companies and Railtrack and a lot of that flavour was in the results that Mercer’s came out with. I should not speak for the train operating companies but all the available evidence suggests that the relationship between them and Network Rail is now much more positive and productive. Similarly, Mercer’s work was done before the SRA was created. Subsequent to that we put in place a concordat setting out the arrangements between the Strategic Rail Authority and the ORR to try and build a relationship there, so I think an awful lot has happened since that piece of work was done and, although I am not going to claim by any means that we have reached a state of perfection, it is an improvement over two years ago.

**Q20 Mrs Browning:** Mr Bowker, on that same page 9 it says, “Poor industry relationships and general lack of leadership” and then goes on to talk about the Strategic Rail Authority being created to bring leadership to the industry. Could you comment on the report we read in the *Telegraph* this week on Monday of this rather unenviable slagging match between the Strategic Rail Authority and Network Rail?

**Mr Bowker:** I think on the specific issue of the creation of the Strategic Rail Authority there was a desire to create some leadership; that was clear from the Transport Act 2000 which created the Strategic Rail Authority, and we have done that to the best of our ability and there has been some success in doing that. The report that appeared in the *Telegraph* was yet one more example of reports that often seem to appear in the press from time to time. The reality tends to be extremely different. The relationship between the Strategic Rail Authority and Network Rail is by and large extremely good. We do occasionally disagree on some matters and we tend to work extremely hard to resolve those matters professionally and amicably and, by and large, we do so.

**Q21 Mrs Browning:** But you will be aware of this Report; it is very concerning. For example, it is talking about a £9.7 billion projected portfolio of which you are claiming only half, and costs arise from either direct costs and construction. Is not that a matter of great concern to you?

**Mr Bowker:** It would be a matter of great concern but I think it is worth pointing out that the calculations that were referred to in that piece form a part of a whole suite of calculations that we did and have done over the last 18 months or so; they provided a great deal of the input that we put into Tom Winson’s access charges review, and a lot of the concerns that we identified are being addressed, so I am afraid to say that what was being discussed in that piece relates to some quite historic information.

**Q22 Mrs Browning:** But when you have two people, one from Network Rail and one from the Strategic Rail Authority and Iain Coucher of Network Rail—having this exchange in the press on the record, it should have been. Certainly I do not think there was much dispute; there was a difficult relationship does not give any confidence that these relationships between these various bodies that need to work together and work constructively together are any better than when Mr Rowlands identified a historic case for us just a moment ago? Try and convince me.

**Mr Bowker:** I can categorically tell you that they are. It is the job of the press, as I have observed over the last two and a half years, never to report the 99.9% of excellent relationship that carries on on a day-to-day basis but to work very hard, with apparently some considerable success, in identifying those areas where there is disagreement. This is a relatively new industry with some extremely competent and highly motivated individuals and in any such circumstance, every now and then, those individuals will have disagreement. It is a sign of maturity, in my view, that that happens, but on the particular matter of the West Coast Main Line, which was one of the items identified in that Report, the working relationship between Network Rail and the Strategic Rail Authority is extremely good and that is why that project is back on track and is going to be a great success for this country.

**Q23 Mrs Browning:** But in order to get the success that we all want to see, throughout this whole National Audit Office Report, it is out-dated management practices and poor communications between the various bodies that show that progress is constantly impeded. We started off with the way Mr Rowlands described a historic situation. I cannot see how you are ever going to improve, meet targets, work effectively together and create some synergy between you, unless you are going to share information and deal with things in a “mature” way—your words—rather than us having to read about what is—I am sorry—nothing more than a slagging match in the press?

**Mr Bowker:** Mrs Browning, if we were to evidence the correspondence and the detailed analysis that passed between the Strategic Rail Authority and Network Rail over the West Coast Main Line, you would not need the pages of the *Daily Telegraph* to record it but something probably akin to the Oxford Library. There is an astonishing amount of correspondence and very hard work that has gone on between those two organisations to put what was an absolutely disastrous project under Railtrack back on track, and it has broadly worked. That project is happening now; it is meeting its milestones; and it is largely down to the very effective project work between not just the Strategic Rail Authority and Network Rail but also all the train operators involved, and I would defend absolutely the fact that the story of the West Coast Main Line and many other projects over the last 18 months/two years is evidence of an improvement in relationships, not the reverse.

**Q24 Mrs Browning:** But there is a responsibility on the Strategic Rail Authority because the Strategic Rail Authority was created to bring that leadership
to the industry. Mr McAllister, from Network Rail’s point of view, how do you see these obvious difficulties of communication?

Mr McAllister: There may be blips like that. I do not know the particular circumstances of what the reporter was asking but if he was asking, for example, “Is there any truth in the story that costs are high?”, I would expect our people to answer and give the information to the journalist appropriately. What the journalist may make of that is entirely up to them, and I often read stories in the press that, quite frankly, I find incredulous and I do not know how they are arrived at, and, frankly, I ignore most of them. As Richard Bowker has already said, the relationships between ourselves and the Strategic Rail Authority are very good indeed. We have regular communication, and there is a complete sharing of information.

Q25 Mrs Browning: But Mr Coucher—who presumably is known to you?

Mr McAllister: Very much so.

Q26 Mrs Browning:—is quoted as saying, “it is a shame the Strategic Rail Authority did not come to talk to us about this”. Why did they not?

Mr McAllister: You may be looking at a different version of the newspaper than the one I saw—

Q27 Mrs Browning: It is right at the bottom. I will ask you to look at it when you get home!

Mr McAllister: It depends what edition you have. I cannot add anything to what I have already said.

Mrs Browning: Can I just say to you, gentlemen, and thank you for responding to my questions, that I think the National Audit Office have picked up a theme, there is clearly an historic basis for it, but I think it is something I would hope you would address seriously, because I cannot see from the answers you have given me that there has been that much progress. Not in this area.

Q28 Mr Steinberg: Mr Bowker, I cannot resist this, I am sorry, but there was an article in the newspaper recently which said that you hired Mr Steve Norris to show you how to deal with the Committee of Public Accounts and that it cost £1,500 for an hour out of public funds. Was the advice worthwhile?

Mr Bowker: I have to say, and you will forgive me for not being able to resist this, Mr Steinberg, that it is another example of the media being highly selective in their reporting of what happened. It is true that we used the services of Mr Norris in that capacity. It is not true that it was for an hour and, in fact, it involved a very considerable amount of preparation time. I think it is entirely appropriate for us to use external advice where that advice is relevant and where it does not exist internally, which in that case it did not.

Q29 Mr Steinberg: Did you find that the advice was good?

Mr Bowker: I certainly believe that the advice we paid for represented value for money, yes.

Q30 Mr Steinberg: For the taxpayer?

Mr Bowker: All our expenditure—

Q31 Mr Steinberg: Who have you been to before this meeting?

Mr Bowker: We did not feel the need to do that because that was the first time I appeared before the Committee of Public Accounts and I did not feel I needed to repeat the exercise.

Q32 Mr Steinberg: Can I just give you some information? I am retiring at the next election, and I can honestly tell you that I will charge half of what Norris charged, so I will give you my card at the end of the meeting!

Mr Bowker: I will take you up on that, Mr Steinberg.

Mr Steinberg: Mr Armitt, I watched television the other night, I think it was during the weekend, and I watched the news on TV and it was announced by Mr Crow that the union was going on national strike, and I thought, “Oh, dear me, here we go again, the same old rhetoric that we have heard for years and years and years”, but then I read the Report which was entitled Making a fresh start, and that was a bit ironic, was it not, and I thought “Here we are, a fresh start, and we have a national strike looming in the next few weeks or so”, but then I read the Report and I got to paragraphs 2.31 and 2.33, if you would like to turn to them, on page 20. Shall I finish this after the vote, Chairman?

Chairman: Just finish your question and then they will have time to think about the answer!

Mr Steinberg: No!

Chairman: You see? I want to give you an easy time but I am not allowed to!

The Committee suspended from 4.00 pm to 4.10 pm for a division in the House.

Q33 Mr Steinberg: As I was saying, if you have a look at paragraphs 2.31 and 2.32, I listened to Mr Crow’s words and thought “Here we go again” but then when I read these particular paragraphs I thought to myself, “I can understand what he is saying now”, because I stumbled across—

Mr Curry: You are lucky!

Q34 Mr Steinberg:—the bonus system for managers and executives, and I can honestly say I did not really understand how it worked but I did glean from it that the bonuses that the managers and the senior executives can expect to receive are 18%, 36%, and, in some cases, 60%. Is that right?

Mr Armitt: The maximum that could be earned under the bonus scheme by directors is 60% of salary, and to achieve that you have not only to achieve targets for the current year but you have to meet all the targets of the year following, so you achieve everything that was expected a year ahead of time. As far as the strike itself is concerned, what has happened is that a ballot has been held—

Q35 Mr Steinberg: I am well aware of what is happening, yes.
Mr Armitt: —but the issues within the—

Q36 Mr Steinberg: The issue, as I see it, is that the ordinary workforce are getting around about inflation, or have been offered around about inflation, increases but the people who they are accountable to are getting bonuses of up to 60%. No wonder they are not happy about it. I would not be happy; I do not think you would be. It is quite outrageous. These huge bonuses are coming out of public money and public subsidy for doing a job that they are supposed to do in the first place—which they are not doing very well anyway. It is incredible. I cannot understand it!

Mr Armitt: When Network Rail was set up it was essentially a requirement that there was a management incentive programme set up for the company, and the programme which was set up was one which the remuneration committee, which obviously the executive directors are not members of so it is the non executive directors, took advice on from external experts as to what was an appropriate level of incentive to put in place to attract the right level of people to the company—

Q37 Mr Steinberg: I have no objection to anybody being paid what they are worth for doing the job but what I cannot accept is that the man, or woman, almost gets double the salary for doing the job that they have applied to do in the first place. Let’s give some examples. I am not trying to be at all rude but what do the executives and the managers actually earn? What is their basic salary? What is your basic salary? I will tell you mine, which is fifty something thousand a year. What is yours?

Mr Armitt: My basic salary is 468.

Q38 Mr Steinberg: 468—?

Mr Armitt: Thousand.

Q39 Mr Steinberg: £468,000? And you get a 60% bonus on top of that, if things go well?

Mr Armitt: If things went extremely well and we exceeded all targets by a significant amount.

Q40 Mr Steinberg: So approximately £300,000 in bonus?

Mr Armitt: That is what could be earned if we met all the targets.

Q41 Mr Steinberg: And what do the poorer executives get?

Mr Armitt: It depends what you mean by the “poorer executives”. The thing about the bonus system is that it is a company-wide bonus system. Mr Steinberg: But you get more than the Prime Minister, and the Prime Minister is running the country and you are running the railway lines—and not very well!

Mr Curry: He is doing better than the Prime Minister!

Q42 Mr Steinberg: You want to get back to the Agriculture Committee!

Mr Armitt: All I can say is that our objective as a company, and at every level in the company, is to pay what is regarded as the market rate for the jobs and the positions held in the company comparable with companies of a similar size across industry as a whole, and the remuneration committee takes advice from external and independent advisers as to what those levels of salary should be to ensure that we as a company, not only at my level but at others, were able to attract the right level of skill and experience into the company if necessary from other sectors across industry as a whole.

Q43 Mr Steinberg: But you did not tell us what the poorer executives are getting. What is their basic salary?

Mr Armitt: Clearly our staff within the company range from, say, £20–25,000—

Q44 Mr Steinberg: But that is not your executives, is it? That is the fellow who is driving the train or—not driving the train but digging the rails?

Mr Armitt: There are a number of senior executives in the company who earn in the order of £100,000.

Q45 Mr Steinberg: And they get bonuses of anything up to 60%?

Mr Armitt: No. Their bonuses would be less than that. They could be up to 30%.

Q46 Mr Steinberg: So could you tell us how much bonus you paid out last year? What were the total bonuses that were paid—out of company funds, remember. It is not as though you are making a profit and paying it out of your profits. You are paying it out of public funds, so what were the total bonuses you paid out last year?

Mr Armitt: Last year we received no bonuses as executives because it was felt that insufficient performance had been achieved in certain key areas. Many employees in the company did receive a bonus of about £600 for their parts in a business which had achieved—at least the signallers and people in Mr Crow’s membership would have received bonuses of about £600 last year.

Q47 Mr Steinberg: Can you understand the animosity that must be felt amongst the workforce when they see the possibility of bonuses like that being paid to a privileged—possibly talented, I am not disputing that—part of the workforce, and they are getting a pittance compared to that? Can you understand why they take industrial action?

Mr Armitt: The issues which people voted on have got nothing to do with the bonuses. As I say, Bob Crow may choose to say that he believes that is an
issue but my experience from talking to people across the company at every level within the company is that it has not been raised with me as a significant issue. The issues which the dispute is about are the pay increase, the percentage this year which would apply across the whole company, the matter of the pension schemes and the free travel. Those are the three issues. I do not believe that the bonus issue is a significant factor in this dispute.

Q49 Mr Steinberg: Well, I can only repeat what I heard him say on the news on the television. Finally, Mr Bowker, is your job basically to protect the public, or is that the Rail Regulator’s? How do you see your job?

Mr Bowker: I have different aspects to my job but I do have responsibility as the accounting officer for the Strategic Rail Authority to be satisfied that the public funds that go into the railway are value for money, however they are then disbursed.

Q50 Mr Steinberg: And you agreed to the bonus scheme, did you not?

Mr Bowker: We agreed to a management incentive plan at the creation of Network Rail and the principles of it which are set out very clearly in this Report, which would incentivise not just the senior executives but the whole company to deliver excellent performance, and I certainly do accept that if Network Rail—and they are now responsible; they have a remuneration committee and the Regulator is responsible for overseeing the policy of this in the future—achieve the targets we are talking about here, then the railway and all the people that work in it are better off as a result.

Q51 Mr Curry: Mr McAllister, I am right, am I not, that you used to run Ford of Britain and you are a non executive director of Scottish & Newcastle?

Mr McAllister: That is correct.

Q52 Mr Curry: Did those companies have shareholders?

Mr McAllister: Yes.

Q53 Mr Curry: And autonomous decision-making?

Mr McAllister: Yes.

Q54 Mr Curry: And the ability to borrow?

Mr McAllister: Yes.

Q55 Mr Curry: Were they exposed to financial risk?

Mr McAllister: Yes.

Q56 Mr Curry: And did they have competitors?

Mr McAllister: Plenty.

Q57 Mr Curry: In that case, how on earth is Network Rail described as a private company?

Mr McAllister: Because it is in the private sector.

Q58 Mr Curry: That is a Jesuit and a tautological response, if I may say so, but describing it as being in the private sector does not give it any of the characteristics of being a private company. Did Ford Motor Company have an “Office of Internal Combustion Regulation”?

Mr McAllister: No.

Q59 Mr Curry: I see.

Mr McAllister: But if a company has a monopoly, as Network Rail has a monopoly, of an infrastructure, then it is standard economic practice to protect the public interest by having an Office of the Rail Regulator, to ensure that the actions taken by the company do not exceed the reasonable requirements of the customer.

Q60 Mr Curry: But there is a whole series of utilities who have price regulators, but they do not have Strategic Electricity Authorities or Strategic Gas Authorities, do they?

Mr McAllister: They do not but I think that question is for Mr Bowker.

Q61 Mr Curry: I am asking you because I want to know whether you think this architecture is necessary. So forget Mr Bowker sitting at the end of the table there—

Mr McAllister: Very well.

Q62 Mr Curry: —and tell me whether you think that, given that this is supposed to be a private company, and you have been Chairman for a bit now, if you were starting again how would you structure it to make it a proper private company?

Mr McAllister: First of all, it is a proper private company—

Q63 Mr Curry: You just told me it was in the private sector.

Mr McAllister: It is in the private sector; it is debt-funded rather than funded by equity through shareholders, as most other private companies are. I would, however, question whether or not it is appropriate for an infrastructure company to be funded by equity through the shareholders because the requirements that we have are to ensure that we operate a safe railway and one that provides financial efficiency to its depots. Now in the case of a company which has shareholders the pressure will be on the company to deliver maximum value to its shareholders. That runs the risk that short-term actions may be taken to improve profits which run against the condition of the assets. So in a company like ours I personally believe it is more appropriate to have a company that is funded by debt so that the immediate pressures on this year’s performance are avoided.

Q64 Mr Curry: But you coupled with that the reference to safety. Do you deny that British Airways has not been sufficiently interested in safety?

Mr McAllister: No, I do not, but the asset conditions are entirely different.
Q65 Mr Curry: Well, you sit there as Chairman. Would you say that you think it is absolutely right that you should have, on the one hand, this Office of the Rail Regulator and, on the other hand, the Strategic Rail Authority? Do you not feel a bit like the baby in the Punch and Judy show?
Mr McAllister: Not particularly.

Q66 Mr Curry: You are a man of extremely wide business experience; you have gone into this job—and I think you probably deserve quite a lot of money for doing something so obviously frustrating as that—
Mr McAllister: My sanity has been questioned!

Q67 Mr Curry: I would not question your sanity on this Committee but what I would question is whether or not in your private moments you do not sometimes think that perhaps the architecture is all a bit complicated and it could all be functioning a bit more simply?
Mr McAllister: I think the architecture is appropriate. We are a monopoly and monopolies are required to be regulated.

Q68 Mr Curry: So three years down the road from now, if you all do very well indeed with incentives which seem to dominate the whole modus operandi of the business, and all comes true and Bob Crow does not go out on strike, or whatever else happens, how do you think this architecture might be changed or lightened? What sort of transition do you see?
Mr McAllister: Firstly, if you look at the initial model of privatisation, you need someone who runs the infrastructure—that is us. Someone needs to run the trains—that is the Train Operating Companies. Someone needs to referee that issue—that is the Office of the Rail Regulator, and someone needs to develop the strategic issues and the long term requirements of the railway and where it fits into the nation’s transport strategy—that is the function of both the Strategic Rail Authority and also the Department for Transport.

Q69 Mr Curry: So you think there is a permanent role here for the Strategic Rail Authority, even when you get on even keel and you perhaps go to the markets to raise money rather than have money under the rather curious conditions you have now, and the Office of the Rail Regulator—they all have a permanent job, these chaps?
Mr McAllister: I would turn it around and say that if we go to the markets, as we truly intend to do, the Office of Rail Regulator is essential to give the markets confidence to invest, and to ensure that the funding of the railway is not changed at the whim of whatever government is in power at the time.

Q70 Mr Curry: Let me turn to this business of performance because I always find it intriguing. For example, by the year 2012–13 it says that the planned target should be a decline of 43% in the delay minutes to 8.4 billion delay minutes. Why 8.4 as opposed to 8.37962? How do you come to this happily rounded figure? What goes into this calculation?
Mr McAllister: We did not.

Q71 Mr Curry: In fact, you were not demanding enough. You were told to bring it down to 9.1.
Mr McAllister: It was a calculation made by the Regulator based upon the improvement in asset condition that would take place over that period of time. That improvement in asset condition resulted in less disruption and delays to the network and, as a result of that, a target of 8.4 million minutes.

Q72 Mr Curry: Do you think that is meaningful? For the punters on the 9.15, most of whom probably think most of those minutes have been spent by them, does it make sense, do you think? Does this target mean anything?
Mr McAllister: It is a projection based upon the condition of the assets as we know them today, and the amount of delay minutes that have been incurred.

Q73 Mr Curry: What would be your estimate of the reliability of projections of this sort? As a businessman, how many things would you expect to go bump in the night between now and the projections?
Mr McAllister: Lots, but the important point is that these projections are reviewed on an annual basis. We are looking at projections each year and are adjusting our targets accordingly. What we have to do is set the target for this year based upon what we reasonably expect to achieve as agreed with the Regulator, and then set our conditions and our objectives in such a way that the organisation goes out to meet or beat that objective.

Q74 Mr Curry: Would it not be more honest in that way, since you revise annually, just to have an annual target? Why have this 9.1 million, or whatever it is, megabytes of delay sitting there, both the Strategic Rail Authority and also the Department for Transport.
Mr McAllister: Our hit rate in terms of success? I am not sure what you mean.

Q75 Mr Curry: Well, it is no good having a target if you do not measure it.
Mr McAllister: We reviewed the plans on an annual basis and adjusted the numbers moving forward but essentially, having set out on store to achieve a
certain level of cost or efficiency by year X plus 10 we set out our plans to achieve those numbers. The issue for a company like Ford is to ensure that the targets are competitive in the market place and they are continually reviewed and benchmarked against what everybody else has achieved.

Q78 Mr Curry: So next time I find myself on a GNER train coming south on a Sunday—something to be avoided at all cost—and find myself doing a scenic detour throughout most of the south of England in order to get to King’s Cross, irrespective of the timings on the timetable, I shall look here and say, “Gosh, it makes me feel much better because in 2008 or 2009 9.1 million whatnots are going to be knocked off”?

Mr McAllister: I think the issue with your detour is the fact that the line is being renewed and, once it has been renewed, the delay minutes will fall.

Q79 Mr Curry: The minutes will melt away?

Mr McAllister: They will not melt away but they will certainly fall.

Mr Curry: I have been told by the Chairman that my minutes have melted away!

Q80 Mr Allan: I think I am following on really from some of the points Mr Curry made on this question about accountability and who is deciding what, and I should probably start with you, Mr Rowlands. In terms of what we want, we want more miles of track renewed or maintained to a higher standard for less money; that is the public interest. Can you describe how we exercise that public interest? Where is that money going? If you have public money, and you are the Department for Transport, how is that getting from you to the people doing the work, sitting next to you now?

Mr Rowlands: You have to break into this at some point so I will break in at the point where the Rail Regulator delivered his interim new conclusions for the five years running from 1 April this year through to 31 March 2009, if I remember right, a five year run, and what he has set out in his interim review determination is a set of requirements that Network Rail are to meet in terms of key performance indicators, so there is a requirement by year for the number of broken rails, for example, and there is a requirement over time in terms of punctuality of the system and so on. He has also determined that an efficient and economic Network Rail should be able to deliver what in the jargon is called the OMR spend, the operational maintenance and renewal spend, that underpins all of that, which is £22.2 billion over five years, and he has included another £2.4 billion for enhancements which are also taking place on the railway. What then happens is that a part of those monies flow to Network Rail through the payment of track access charges by the 20 or so Train Operating Companies, and they are contractually committed to whatever the outputs are underpinned by a subsidy payment that flows from my Department to Mr Bowker in the Strategic Rail Authority with which he negotiates and lets franchise contracts. As it happens, for various in a sense important and technical reasons, some of the money flowing to Network Rail is by means of a direct grant which comes again from the Strategic Rail Authority from a provision we provide out of the Department. In that five year period, the one that has just started, by agreement with the Regulator there is no increase in access charges for the first two years—the additional cost is supported by both direct grant and by Network Rail borrowings—and similarly some of the payment is direct grant, but it is for reasons of government accounting that we need properly to recognise that some of this expenditure on the railway is capital investment—

Q81 Mr Allan: Public sector?

Mr Rowlands: —and some is revenue subsidy, if I can put it in those terms, and if you simply pay it all back by access charges the way it is reported in the accounts it underplays the level of investment in the railway, so by paying some of it as direct grant you probably capture it. That is a bit technical but it is quite important.

Q82 Mr Allan: Part 3 of the Report is entitled, “Network Rail’s governance and financing arrangements are complex”, but it begs the question, and I am not picking on Mr Bowker, why do you need Mr Bowker? You have the Rail Regulator who is coming up with all the figures. Why does the Department not just pay the money to the Train Operating Companies and Network Rail? Why have Mr Bowker in?

Mr Rowlands: Mr Bowker exists because the government created the Strategic Rail Authority in February 2002 to supply a strategic direction to the railway because the conclusion on the basis of the experience of the privatised railway was that an interplay of contracts and contractual interest did not of itself necessarily reflect properly an overall strategic direction from the railway, and in a sense, if you fund it properly, the public interest as expressed through that strategic direction.

Q83 Mr Allan: But it could have been done within the Department. Are you saying you are not up to it so you have to get these other guys in to do it?

Mr Rowlands: It could have been done. I guess, within the Department. It could have been done by the creation of some other kind of body; that was the decision that was taken. I think I would like to defend the Department and say that I guess we would have been up to it had we been asked to do it but the conclusion was to set up a strategic rail authority. Remember, this was out of a background where there was already an existing other body called OPRAF at the time, and it was that body that was letting and managing franchise contracts and, in a sense, that which was built upon, plus the residue of the British Railways Board which actually still exists, which led to the creation of the Strategic Rail Authority.

Q84 Mr Allan: Mr Armitt, from your point of view, is not this just an extra layer of complexity? From Network Rail’s point of view would it not be simpler
just to deal with this Rail Regulator, who is the one who sets the targets, and the government signs the cheques?

Mr Armitt: We deal with the Rail Regulator on a day-to-day basis because he is there to oversee what we do and to ensure that we do it efficiently and effectively, and meet the targets that he sets. He is the one who sets our financing levels. The secondary issue here is who provides strategic direction, and that is a matter for the government.

Q85 Mr Allan: I will turn to that in a moment, but just turning to table 4 on page 14 which tells us about the growth in train miles operated since 1997, I see it dips every fourth quarter. Is that because they timetable fewer trains in winter?

Mr Armitt: That is called leaves on the line.

Q86 Mr Allan: But it says “Timetabled train km” in table 4?

Mr Armitt: That is the difference between the winter and summer schedules.

Q87 Mr Allan: So they do have fewer trains in winter?

Mr Armitt: Yes.

Q88 Mr Allan: I can understand that. An important issue, I think, is that a lot of customer dissatisfaction is that services are not growing as fast as customer demand is growing, which I guess is firmly in the Strategic Rail Authority’s domain, and an example of something which people ask is that from Sheffield to Leeds we have no good service and Virgin Trains are getting very upset because theirs is the only fast service from Sheffield to Leeds, so everyone piles on to the Virgin train which is supposed to be going from Plymouth to Newcastle and not carrying local passengers, and everyone says, “Why can we not have a decent train service between those two points?” I am still confused because presumably that is what you are supposed to be doing as the SRA. You should be delivering us this train service if there is demand.

Mr Bowker: Not only should we be doing it; we are doing it. That is why we published a route strategy for the Midlands Main Line which identified what people wanted, and we are working with South and West Yorkshire PTE and the network and rail operators to look at what it would take to deliver that. That is happening.

Q89 Mr Allan: And if there is a need for improved track or alterations to the track to do that, then you decide because it is one of your priorities to give the money to Network Rail to deliver that?

Mr Bowker: If it involves enhancement of the network in order to deliver that then we have the ability to contract with Network Rail to deliver those enhancements, yes.

Q90 Mr Allan: So you are the people we should come to if we want to press for new and enhanced services?

Mr Bowker: Indeed.

Q91 Mr Allan: Is it therefore your impression that you are keeping up with demand or are you little boys with fingers in the dyke, just stemming things? Because there is a perception out there that demand is growing much more than capacity?

Mr Bowker: It is not growing evenly. If you look across the network you can find parts of the network where demand has grown very significantly. The line you would be aware of, Thameslink Services, has grown dramatically around 60 and 70% over the last few years. Now, there is a limit to your ability to keep pace with that level of demand without investing in major infrastructure. At some point you have to correct staff change, and that is why we are looking at Thameslink 2000 to do precisely that. In other parts of the network there has not been that level of demand. The point really is that somebody somewhere has got to take a long term, strategic view of the rail network and how it interacts with wider economic issues. That is a matter for government. The Strategic Rail Authority is a creature of government, and that is what we do.

Q92 Mr Allan: Finally, Mr Rowlands, you talk about the safety issues here which we know are things that have disrupted the network to a large degree, and the frightening thing about this is that the value per preventable fatality is £1.2 million for the roads and that is going to be applied to the railways, but I guess the point that comes out of this is that there is a potential conflict between safety and government service. We may want a new service but that may, in the opinion of Network Rail, be more than that particular bit of line can take. Who referees that and how are those priorities set?

Mr Rowlands: Can I come from a slightly different direction? In a well run industry there is not, in the sense that perhaps you meant it, a conflict between safety and performance. To pick up the point about British Airways, I do not think anybody would claim within the aviation industry that there is a conflict between safety and performance. There are some issues to do with prioritisation, and that is as true of, say, the roads programme from my Department as it is from investment on the railway, and that is why my Department uses a notion so-called value for life figure in order to prioritise highways expenditure, because there comes a point—and this is all terribly difficult because it sounds heartless—where the monies you are expending on safety are not producing the benefit incrementally and you should not be spending it, so one of the issues for railway is the need to arrive at a basis on which to prioritise railway expenditure, including safety. Historically, I think it would be fair to say that the railways have used a rather higher figure than the one that my Department uses for roads, and the justification for that has been what I think the HSE would call in the jargon societal value of life in terms of public transport as opposed to a driver driving his own car. It is an undecided issue as to what the value for life should be for the railway, and I think ultimately it has to be an issue both for Network Rail
in terms of investments they make backed off against any Strategic Rail Authority requirements but also particularly the Regulator’s position. What I would stress is that I do not think on the railway there is a definitive single value that, if it does not meet this test, we will not make the expenditure. It is a decision tool. You can clearly see at some values it is not sensible to spend the money, but for other safety related projects it is really sensible to spend the money.

Q93 Mr Allan: Network Rail, do you understand you have the same kind of potential legal liability for deaths on the railways that people have suggested in the context of contractors who have worked on the railways and thus caused accidents, and is that a limiting factor, because fear of corporate manslaughter charges is referred to in the Report?
Mr Armit: We accept the simple fact and responsibility that whatever happens on the railways as the owner of the infrastructure it is our responsibility and we have never shied away from that. As David has just been explaining, in making our judgments and decisions about what we should and should not do we do have to take into account these figures. We take a higher figure into account very often because the potential of an accident could result in multiple deaths rather than a singular death, and because of the multiple death aspect we typically might be using a figure of £3.5 million as opposed to £1.2 million.

Q94 Mr Jenkins: Mr Rowlands, when you got the Report, were you surprised by the findings of the Report? Did you expect it, or do you know about it?
Mr Rowlands: I was not surprised because I think the Report in a sense rightly reflects the position that Network Rail and, indeed, the railway industry finds itself in. This is unfinished business and it comes down to this Report and I do not think the Department will either want to pretend that it is anything other than unfinished business. It is a fresh start; it has clearly made, particularly Network Rail, progress in the last 18 months since it came out of administration, but there is still a way to go in terms of performance, in terms of cost control and issues like—

Q95 Mr Jenkins: Yes, very much, and it is about how and why we got into this mess to start with and the fresh start was needed. Railtrack put us in this mess and the Department was overseeing this system at the time. Can you tell us what your job and role was from 1996 to 2003.
Mr Rowlands: I was, prior to becoming Permanent Secretary in June last year, six years as Director General responsible for railways, aviation, logistics, maritime and security.

Q96 Mr Jenkins: Let us get this clear. You were the person responsible for the running and the well being of our railway system.
Mr Rowlands: No. I think the strict and accurate position was that the private sector companies in the industry had the immediate responsibility and, in terms of Railtrack as a regulated monopoly, the responsibility thereafter rested with the Rail Regulator and not directly with the Department.

Q97 Mr Jenkins: So, the Director General of Railways was merely a title.
Mr Rowlands: I think it was a little more than that. Let us be clear. The Regulator was responsible for regulating the performance of Railtrack as it was.

Q98 Mr Jenkins: Blame the Regulator, blame somebody else, but the Department is responsible for running the system and the buck stops somewhere, so where does it stop?
Mr Rowlands: What happened was that, in 2001 after the Regulator had reached what was then his five year review conclusions, Railtrack asked on more than one occasion for additional funding and other things and it was on that basis that ministers concluded that they did not wish to give further finance to Railtrack and made application to the High Court.

Q99 Mr Jenkins: Mr Armit, in the Report, it mentioned several times the new increased level of funding and it mentioned that the pre Hatfield levels are now 30% higher, but nowhere in the Report—one and you have had your chance to look at this Report, alter this Report or put forward your comments on this Report—did you point out where it says it was the pre Hatfield level of funding that caused us to have a decaying railway system.
Mr Armit: It is obviously not for us to write the Report. I think it is well documented and many people have commented for several years now that there has been a very significant under level of investment in the railways pre privatisation let alone post privatisation and the level of investment was actually increasing. I believe, in Railtrack’s defence, from a low in 1993–94, it had actually increased through 1995–96. The level of investment now is clearly significantly greater and I think does reflect the much greater understanding that we have of the overall state of the infrastructure and the need for investment than clearly existed at that time.

Q100 Mr Jenkins: We are not opposed to levels of investment. What we are trying to do is establish whether we do get value for money out of that investment and it is your job to convince us that we do get value for money out of that investment. The one thing that surprised me is when Mr Bowker, in reply to one of Mrs Browning’s questions, said that this is a relatively new industry. Explain what you mean, please. I think that trains have been around for a few years. Why is it a new industry?
Mr Bowker: Because, in private sector terms, it has only been since 1994 that any part of this industry was in the private sector.

Q101 Mr Jenkins: Like a ballpark, we start at year zero—there is no history, no facts, no skills and no base on which to run a railway system.
Mr Bowker: I never said that.

Q102 Mr Jenkins: So, it is not a new industry. It might be a new administration to run the industry but it is a fairly old industry albeit that it ran aground and was destroyed by the management at the time.

Mr Bowker: No. I was very specific in the answer to Mrs Browning’s question that I was talking about private sector involvement since 1994. Since then, this industry has had a great deal of it in the private sector, it has been privatised. I accept that it is an old industry; it celebrates its 200th anniversary this year.

Q103 Mr Jenkins: Both Mr Rowlands and Mr McAllister said that what we have is a private sector company. Can you tell me of anywhere else where a private sector company is set up and its bid and arrangements are funded by the state in this way?

Mr Rowlands: I know of no parallel example to Network Rail but then I know of no example of a railway being put into administration and the Government needing to ensure that there was at least a viable proposition in front of the administrator to bring it back out of administration. So, in that sense, no, I do not.

Q104 Mr Jenkins: In other areas, we call it arm’s reach management or arm’s length companies. In other words, they pretend they are not a part of us but we actually do still control them.

Mr Rowlands: No. The Companies Act actually provides two kinds of private sector company; one the well known and traditional equity based private company but it also provides under the Companies Act for something called “company limited by guarantee”. The Report acknowledges that Glas Cymru, for example, in the water industry, transformed itself into a company limited by guarantee and there other companies around, not many but there are some of substance, which do not have private sector shareholders: BUPA is another example. So, it is not as if something like this has never existed. It is certainly the case that something like this is uncommon, certainly on this scale in the United Kingdom and, as I say, in one sense, it is perhaps a consequence of something happening which had not happened before which was that a railway went into administration and had to come back out.

Q105 Mr Jenkins: This company can borrow money in the market and it is underwritten or supported by Mr Bowker with large pockets which in effect is supported by you and your Department. This is a nice arrangement, is it not? What incentive is there for you in your Department to ensure that the risks that you are now exposing us to in this, namely the taxpayer, are closely monitored?

Mr Rowlands: The SRA monitors on a quarterly basis the financial position with Network Rail. We in turn monitor the SRA’s financial position. You asked what incentive we have. The incentive we have is basically to get out of as much of this £21 billion arrangement as we can and the route out is for Network Rail to securitise its forward income stream off the back of which it will be able to issue its own bonds and as a result of which, if that is successfully undertaken, the £21 billion progressively disappears. What will be left, for the moment at least, would be, if we look at the diagram setting out the detail of the £21 billion on page 30, you will see down the bottom there is something called “Opco facility Tranche A” with an expiry of transfer date of 2052. That is a 50-year facility. The Network Rail securitisation should progressively take out all the elements of this package other than the £4 billion which is a long-term safety cushion should there be some serious financial position arising in Network Rail, and the incentive for them not to dip into that facility is that if they touch more than 5% of it, then either the SRA Board or the Network Rail Board can dismiss Mr McAllister and Mr Armit and, if they get so far as to eat up 80% of it, the SRA can actually remove all the other membership.

Q106 Mr Jenkins: When I started, I had a two-minute warning on my time and you have used those two minutes up! I was asking Mr Armit about cost standards of work in comparison with different industries, different companies and if you have a change of culture in your organisation and with your staff, as was mentioned before, you really have to work on your staff development. It is asset maintenance I want to ask my last question on. Yesterday morning, I was at my local railway station and my local railway station is the most rundown depleted part of my town. As an interface between the railways and their customers, it is an absolute disgrace. It is litter strewn and its dirty, dingy and filthy and no money has been spent on it and across on one platform we have a bus shelter and that is what I have to walk on to get the train to London because I get the train a lot and, when I get back at night, the station is actually shut and I get off the train and I walk in a hole in the concrete fence to the car park and walk around it! If I were alone, even I would be a bit wary. It is not a welcoming sight. I know it is difficult and I know we have little money, but remember that this is the interface between the public, your customers, and the system itself and when I see all the work done on the tracks, I think, why do they not spend a little more money on the stations? What can you do to give us a guarantee that money is going to be spent in these stations to bring them into the 20th century let alone the 21st?

Mr Armit: Certainly in the allocation of funds going forward in the next five years, there is in fact—I speak from memory—I think about £670 million which is allocated to stations and that will be prioritised across 2,500 stations across the network. I believe the important thing is that very point you have made, that in fact the stations to a large degree are the shop window of the railways, they are the first thing that people encounter. I am sure that I get as irritated and frustrated as you do at times by the litter and other things which accumulate around them. We can always do better and we are
Mr Bowker: We have support from the Department that, if those funds were called—

Q114 Mr Bacon: You say “support”; what do you mean?

Mr Bowker: We have support from the Department. They have said to us that, if that ever happened—and it is important to remember the remoteness of that event ever happening and the purpose that equity buffer actually provides—then we would be kept in funds.

Q115 Mr Bacon: So, the Department would give you the money?

Mr Bowker: Yes, but I—

Q116 Mr Bacon: That is if that were to happen. Mr Rowlands, if this happened and you had to give Mr Bowker some money in order that he could lend it to Network Rail, where would you get it from?

Mr Rowlands: In the event that we needed funds, the first call would be on the Department’s existing provision and, if that were insufficient, then no doubt we would need to talk to Her Majesty’s Treasury, but that is equally true of any other financial pressures that may happen in the Department.

Q117 Mr Bacon: Where would the Treasury get it from?

Mr Rowlands: The Treasury would get it presumably—

Q118 Mr Bacon: Where would you get your existing provision from?

Mr Rowlands: Voted by Parliament.

Q119 Mr Bacon: What would be the cost of this money if you had to go and get it?

Mr Rowlands: It would be presumably—

Q120 Mr Bacon: Would it be correct to say that it would be cheaper than what you are doing at the moment?

Mr Rowlands: Well, you can see in this Report—

Q121 Mr Bacon: Is that a “yes” or “no”.

Mr Rowlands: . . . that the figure is £25 million cheaper across the piece for its entire network—

Q122 Mr Bacon: I do not really understand the answer to Mr McAllister’s question earlier. What is the taxpayer getting for this £20 million to £35 million of extra expense for borrowing?

Mr Rowlands: It is getting a company in the private sector subject to market discipline with the kind of management you would find difficult to attract to a state owned railway.

Q123 Mr Bacon: What is the long-term financing cost for Network Rail?

Mr Rowlands: Let us go back to the Regulator’s interim review determination. Its OMR costs will be £22 billion over a five-year period to be met by—
Q124 Mr Bacon: That is medium term; I am talking about long term. Mr Colman, is it correct that the Report basically says that the long-term funding costs are unknown?

Mr Colman: They are unknown because long-term funding has not been put in place.

Q125 Mr Bacon: That is what I thought. So, therefore they are unknown. That was the answer I was looking for. They are unknown, are they not, Mr Rowlands?

Mr Rowlands: Yes because they have not been put in place but we do have—

Q126 Mr Bacon: Why, two years after Network Rail was created, have you still not put in place long-term funding? It is over two years since it was created. When was it created?

Mr Rowlands: It was created in October 2002, some 18 months ago.

Q127 Mr Bacon: I thought it was in March 2002. Mr Rowlands: No, it came out of administration in October 2002.

Q128 Mr Bacon: But it went into administration in October 2001?

Mr Rowlands: Yes.

Q129 Mr Bacon: So, the work was going on two-and-a-half years ago and then, 18 months ago, it was finally set up as Network Rail; is that correct?

Mr Rowlands: It came out of administration into Network Rail.

Q130 Mr Bacon: Surely, if there were a period of 12 months for it coming out of administration, was not part of the purpose of it being in administration that, when it came out of administration, you would have its long-term future put in place and you would know what its long-term financing arrangements were?

Mr Rowlands: No. To go back to a point I made earlier, this is unfinished business. It came out of administration as a company with scant idea of its cost base and with no asset register. The first and immediate issue was to stabilise its short-term financing position which you see with the £21 billion facility and the £9 billion bridge facility for example. The next step was to put in place a medium-term programme and £6.5 billion of that went into place in recent weeks. The next step is to move to a long-term securitised stable long-term funding position. We cannot tell you the cost of that because it is not in place. We do know from the medium-term loan programme and the short-term borrowing, that is about 20 to 35 basis points above LIBOR, from memory, currently costing in excess of £20 to £30 million a year more than if it were direct Government funds.

Q131 Mr Bacon: Is the £9 billion bridge facility you referred to being put in place first?

Mr Rowlands: It was put in place at the point, if I remember rightly, where Network Rail came out of administration.

Q132 Mr Bacon: Is it correct that the Department was warned in 2001–02 that its proposals for a long-term funding strategy were undeliverable?

Mr Rowlands: No, it is not.

Q133 Mr Bacon: Could you turn to page 29 where figure 13 talks about proposed adjustments to the regulatory asset base and, in 2003–04, it looks like only £303 million of these adjustments to the regulatory asset base were actually due to network enhancements. Why were costs that were not for productive investment added in?

Mr Rowlands: This is an adjustment which the Regulator has made to the regulated asset base in respect of expenditures which were not provided for in his original five-year periodic review determination but which he has regarded subsequently as legitimate. So, there is, for 2003–04, £303 million of enhancement expenditure which was not included in his original determination but is now included in the regulated asset base.

Q134 Mr Bacon: Can I ask you to turn to page 11 where, in paragraph 1.23, and I am quoting from the bottom of that paragraph, the NAO says, “In our opinion, the SRA could have taken a different, and more restrictive, stance for 2003–04 spending on the basis that, by then, Network Rail would have had a significant degree of control.” I suppose this is a question for you, Mr Bowker. You let them go ahead anyway on the old basis. Did this not expose the taxpayer to an undue level of risk?

Mr Bowker: We do not actually think we could have taken a different and more restrictive stance and the reason is very, very clear: because we had to get the company out of administration. Had the Department made an application to the Court to do that without the Court being clear that Network Rail would have remained solvent coming out of administration, they would not have discharged the administration order. So, it was extremely important that we could demonstrate ongoing solvency. Network Rail was created, as David said, with very little information and very little knowledge about its assets, but it was essentially to demonstrate to the Court that the company would remain solvent. That is why we did what we did.

Q135 Mr Bacon: Mr Rowlands, according to paragraph 3.21 on page 31, it says that, “... Network Rail, the Department and the SRA are confident that a debt insurance programme will go ahead in 2004” but it goes on to say that there a number of things which need to happen. “The outcome of the access charges review, statements by the Government and Network Rail, and the structure of the borrowing arrangements will need to satisfy rating agencies” etc “that Network Rail will be able to meet its debts service obligations ...”
This was published only a couple of weeks ago; you are not yet in a position to confirm that all these things have been put in place, are you?

**Mr Rowlands:** We can confirm the track access charge regime from the interim review did take place and—

Q136 **Mr Bacon:** Mr Rowlands, I really want you to answer “yes” or “no”. I was asking, you are not yet in a position to confirm that all these things are done and in place, are you?

**Mr Rowlands:** I can confirm that the first is in place—

Q137 **Mr Bacon:** I am sorry, I was not asking you to confirm what you can do. This list is not yet complete, is it?

**Mr Rowlands:** No.

Q138 **Mr Bacon:** That is all I was asking. In what circumstances would you be prepared to put Network Rail into administration?

**Mr Rowlands:** I do not think I can answer that question. The position is that the Railways Act 1993 provides for a special administration regime for the network licence holder who is unable or likely to be unable to pay their debts. That is the position. I cannot say and I certainly do not expect Network Rail ever to be in that position.

Q139 **Mr Bacon:** Mr Molan, Mr Rowlands said that the Department did not receive a warning that the financing strategy that was proposed was undeliverable, did the Treasury?

**Mr Molan:** I am not aware of that, no.

Q140 **Mr Williams:** Mr Armitt, you joined Railtrack in December 2001 and you came with a distinguished record with established private sector companies: Chairman of John Laing plc followed by Chief Executive of Costain and you were Chairman of Union Railways. So, considerable business experience. If we look at pages 8 and 9—and you do not need to look, I will read it out—under the main subheadings, it says that, “The Department identified Railtrack’s major shortcomings” as “Under-investment in the infrastructure”, “Poor value for money management...”, “Loss of engineering skills and asset knowledge” and “Poor industry relationships and general lack of leadership.” How long did it take you to realise that you had inherited an absolute shambles?

**Mr Armitt:** Given that I was appointed by the administrators three or four months after Railtrack was put into administration, I went into the job realising that probably, yes... Clearly, things—

Q141 **Mr Williams:** Did you realise the scale of it? How long did it take you to realise the scale of it or would you say that you went in fully aware of the situation?

**Mr Armitt:** I certainly did not go into it fully aware of the degree to which there had been under-investment and the degree to which there was a need for significant increase in the investment and state of the infrastructure, and clearly that and the lack of Railtrack’s ability to fund that and minimise the degree to which it was going to have to fund itself going forward, of course—

Q142 **Mr Williams:** So, once you got in there, these were not minor shocks, they were quite considerable shocks.

**Mr Armitt:** Yes and no. Having taken interest in the railways in the past, one was aware that British Rail itself, before Railtrack, had gone through some difficult times for a very long time and therefore the industry and the infrastructure of the railways was one—

Q143 **Mr Williams:** At paragraph 1.18, it makes the point, “Railtrack’s knowledge of the condition of its assets had deteriorated since privatisation so it did not know what needed to be done to put problems right, how much it would cost, or what the risks were.” Were you aware of that when you went in or was that something you discovered yourself?

**Mr Armitt:** Certainly that was something which one grew to understand and, as you looked inside the company and understanding the company, it was a direct consequence of the decision that privatisation and the need to outsource totally the maintenance activities and with that went an enormous amount of information away from Railtrack, Railtrack having decided fundamentally that it wanted to be the owner of an asset which it employed others to look after.

Q144 **Mr Williams:** Was the seriousness of this lack of information about the condition of its assets immediately apparent or was it something that you discovered subsequently?

**Mr Armitt:** That had been understood before I arrived and work was in place to actually put in programmes and the Regulator had understood that.

Q145 **Mr Williams:** What I do not understand is that, in paragraph 1.21, it says that the Department carried out in June 2002, that is seven months after you were appointed, an evaluation of the bid and it says that, in carrying out this evaluation, “As the realities of the situation (such as the poor quality of data on asset condition) become clear, the Department realised that the depth of the analysis that Network Rail could carry out, and therefore the detail of the plans it put together, was limited”, but they did not seem to be aware of that or become aware of it, according to the wording here, until they were in the process—and I do not know whether you were there, Mr Rowlands, at this stage. I do not know whether they were aware of this in advance because, reading this, it seemed that a sort of sadness dawned on the Department as it was trying to evaluate the bid. Which is correct: Mr Armitt saying he felt it was implicit in the situation or, as stated here, it came as a surprise to the Department?

**Mr Rowlands:** Can I try to help? I do not think there is a tension between those two points. What became clear with Railtrack in administration was the
administrator’s growing inability to put together the
data room you would have needed to invite bids
from the outside world because, the more he got into
it, the more they discovered that the information was
not there in terms of the asset base and so on. From
Mr Armitt’s perspective, what he is saying is that
clearly there were serious problems with this
company four months after it went into
administration and, in that sense, he knew there
were difficulties.

Q146 Mr Williams: In that case, Mr Armitt, if you
felt it was rather complicit in the situation, had you
done anything to try and put it right between then
and the time the Department had to carry out this
evaluation in June?

Mr Armitt: Two things were going on at the same
time. There was in place an exercise—and it is
continuing today—to improve and build up the
knowledge of the asset base. That was going on at
the time I arrived. The Regulator had in fact
required Railtrack to put in place action to improve
knowledge of the asset condition. In a bid situation
such as you have after this organising, the ability of
the administrator to lay his hands on sufficient
quantity of information to enable Network Rail to
put their bid together was limited.

Q147 Mr Williams: It needed to be much more
precise?

Mr Armitt: Yes.

Q148 Mr Williams: If you look at paragraph 2.31,
we come to this question of incentives and it says
that, “Inappropriate commercial incentives played a
large part in Railtrack’s problems, so having the
correct incentives for Network Rail to perform well
is extremely important”—that is a strong statement
in National Audit Office terms. “Network Rail’s
own incentive schemes have a direct effect on
managers’ bonuses and are therefore of key
importance.” This is interesting. This incentive
system was seen as absolutely central. It goes on—
and I promise you it will be shorter dealing with it in
this way—in paragraphs 2.34 and 2.35, we find that
the NAO looked at Welsh Water which was a non-
profit company, they looked at the oil industry, the
air traffic industry and Deutsche Bahn, the German
railway company, and they all came up with a form
of incentivisation which you or the Department
seem to have rejected. Why is that?

Mr Armitt: I do not think we have. The fundamental
point of view is, do we have an incentive for financial
efficiency, and we undoubtedly do have. A key part
of our efficiency regime has been financial efficiency.
It is called the FEI, it is there to measure the
efficiency with which we spend money and the
efficiency with which we carry out our duties.

Q149 Mr Williams: I do not quite read it that way
because, if you go on to paragraph 2.36, again you
have to watch the wording very carefully because the
NAO is very cautious about its wording and that is
often what much of the arguing takes place over
when they are agreeing the Report with the
Department. To follow on from those examples,
“the circumstances of other businesses will differ”
and then it says, “the Department, SRA and
Network Rail see some attractions to such a measure
they consider it is not possible to develop a
meaningful one in Network Rail’s context.” Can we
come to the Audit Office. Usually, with the Audit
Office, we do not differentiate with the base audit
with the National Audit Office. It is not just a
statement that there was not a possibility to do that,
it just says that they considered. Does that mean that
you disagree with their summation?

Mr Colman: We thought this was an idea worth
considering and that suggestion is their view.

Ms Leahy: I think we thought that for any measure
to be really effective, the company would have to
own it and feel that it was worth having. So, we
noted really that other industries had such measures
and found them valuable. We thought there were
attractions but we put it in the way that we did
because, if the company did not actually agree, then
we felt it probably would not be useful.

Q150 Mr Williams: You then go on to criticise them
having made the incentive system the centre of the
recovery programme probably, you then go on in
paragraph 2.37 to throw doubts on the long-term
element, which is essential, in the plan which they did
accept. Was this a subject of much dissertation
between you or was this section agreed relatively
easily?

Ms Leahy: It was certainly discussed quite
extensively, so I think we probably understood the
company’s view on this. My own view, if I am
allowed to comment on this, is that it is the sort of
concept that might take some working up and that
they might well work through after this and decide
that there was something like this that would be
worthwhile.

Q151 Mr Williams: It is more than a slight
disagreement. There is a fundamental difference of
approach here because they take themselves into a
rolling three-year programme about which you have
considerable doubt. You say, “Over a normal three
year period insufficient spending on maintenance
work may save money and lead to increased rewards
under the plan, but years later translate into
increased delays.” So, it is not a matter of you just
introducing something temporary, they are
introducing something medium term and now seem
to have turned their back. There is no work being
done I assume in the organisation, Mr Armitt, in
relation to draw on the experience of these other
industries to see how far they could be relevant to
you.

Mr Armitt: We are more than willing to do that.

Q152 Mr Williams: You may be more than willing
but have you done it or are you doing it?

Mr Armitt: We are in the very early stages of this
incentive plan and the criteria which are used at the
moment, which is asset condition, financial
efficiency and performance, the objective of having
those three is that you cannot actually play one off
Mr Jenkins: It always seems strange that you are handing out subsidies and handing them back to the people rather than . . . If it really was an incentive, there really was a marketplace, we would not be handing out £1,000 million a year for subsidy.

Q157 Mr Bacon: Mr McAllister, I read in the Report that you have net debt of around £12.8 billion and it is expected to rise to around £17 billion in this coming financial year; is that right?

Mr McAllister: Yes.

Q158 Mr Bacon: On page 30 of the Report, the chart talks about Network Rail’s acquisition and initial finance arrangements. It does not cover all of those figures, I do not think. Certainly in terms of what is drawn down, there is no way that you get to £12.8 billion. In fact, it comes to £9.19 billion. Do you see the second column, “Amount drawn down as at 31 March 2003” and admittedly that is a little out of date now but is it simply that, since then, there has been another roughly £3.8 billion drawn down?

Mr McAllister: Yes.

Q159 Mr Bacon: Mr Armitt or Mr Rowlands, could we have an up-to-date chart sent to us to include in the report showing all the borrowings, the gross borrowings and the net borrowings and, in every respect, the exposure of Network Rail and of the ORR who have an overriding view of this will do so.

Mr McAllister: It is really for Mr Rowlands to say that this line presumably describes the money that is definitely going to Network Rail through its track access charges and that is pretty much fixed as to what Network Rail gets.

Mr Rowlands: Network Rail’s income through track access charges is contractually committed.

Q160 Mr Allan: Looking at table 5 on page 16, the one that gives us the annual OMR, other maintenance renewal costs over the next few years, it is really for Mr Rowlands to say that this line presumably describes the money that is definitely going to Network Rail through its track access charges and that is pretty much fixed as to what Network Rail gets.

Mr Rowlands: Network Rail’s income through track access charges is contractually committed.

Q161 Mr Allan: If they come in under that and if they are able to perform better, they build up cash in the bank?

Mr Rowlands: They build up surplus, yes.

Q162 Mr Allan: Nothing comes back to the taxpayer during this period?

Mr Rowlands: I think that is right, yes. The issue would then be for the Regulator in the next five-year period to take account of that.

Q163 Mr Allan: So, the net overall effect of this chart we see here is that it is very clear that, by the end of this period, 2008–09, the travelling public will have

1 Ev 19
paid considerably more for their rail network and have considerably less done than perhaps might have been envisaged in 1998–99.

**Mr Rowlands:** The taxpayer pays more, the travelling public pays partly regulated and partly unregulated fares. They will certainly have had more done physically on this railway than was in Mr Windsor’s original five-year determination. If you just look at track renewals, this will be 850 kilometres a year for five years, vastly more than was happening just before or after privatisation.

Q164 Mr Allan: So, they will pay more to the taxpayer and have more done?

**Mr Rowlands:** Yes.

Q165 Mr Allan: And you think this is the most efficient structure you now have for that?

**Mr Rowlands:** Yes.

Q166 Mr Steinberg: Has the advice that Mr Norris gave you the last time helped you for this meeting and give us an example of how it has?

**Mr Bowker:** I think it would be very difficult to be that specific.

**Mr Allan:** That was the example!

Q167 Chairman: Mr Bowker, could I just follow up one point lastly as well. You will recall that, at the beginning of this meeting, I referred you to paragraph 3.4 which you will find on page 25 and I was putting to you that maybe your degree of influence over Network Rail was somewhat limited. If one reads that paragraph, it says, “The Regulator’s access charges review conclusions stated that he felt it would be inappropriate for him to prescribe a rigid framework of route differentiation and that Network Rail should make these judgments itself. This makes the SRA reliant on Network Rail’s own commitment to the goals to which the SRA is committed.” In answer to Mr Bacon, you seemed to admit, although with one or two qualifications, that you viewed Network Rail as a subsidiary of the SRA. This is your opportunity, particularly given what is written in that paragraph, to state to us whether you really think that you, who are supposed to be the arbiter of strategic policy in this country upon the railways, have sufficient powers over Network Rail.

**Mr Bowker:** I have made clear as part of the Secretary of State’s review of this industry that I think it is worth considering there being a single specifier who specifies the outputs in the public interest for the railway to deliver. That is not currently the absolute position and that is why we have made that recommendation.

Q168 Chairman: Mr McAllister, again following the line of questions Mr Bacon was asking you, if you, please, look at page 31 and paragraph 3.19—and I do not think that Mr Bacon actually referred you to the paragraph in the Report and therefore, in terms of long-term debt finance, it is important that we get this on the record—you see there that you do not have a long-term future in terms of finance. Would it not have been easier to have issued bonds in order that you could have a lump sum available to you and under your control?

**Mr McAllister:** That is what we are planning to do. The reason why it has not been done is because the Regulator had not determined his final settlement. Now that he has done so and our revenue stream is fixed for the next five years, it is our intention to securitise that income stream and issue bonds.

Chairman: Gentlemen, thank you very much for appearing before us and for answering our questions. We thank Mr Steve Norris for the advice he has given to you. I think we will want to in our report refer to various matters: the extra expense of borrowing, the complexity of governance, bringing costs under control and the kind of incentive targets that we see particularly on the cost. Gentlemen, thank you very much for your help this afternoon.

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**Letter to the Committee from the Legal Services Director, Department for Transport**

The purpose of this letter is to provide you with additional information about the legal action that the Railtrack Private Shareholders Action Group (RPSAG) has now commenced and to raise some of the potential hanging issues.

The litigation is an action by the Railtrack Private Shareholders’ Action Group against the Secretary of State for Transport and the Department for Transport. The claim alleges misfeasance in public office and a breach of Article 1 of the First Protocol to the European Convention of Human Rights (protection of property). The claim is that the defendants devised and implemented a plan to expropriate the assets of Railtrack Group, with the specific intention of harming shareholders. At the relevant time, David Rowlands was the Director General of Railways, Aviation, Logistics and Maritime in the Department for Transport, Local Government and the Regions advising the Secretary of State in respect of this matter. He is, therefore, a key witness for the defence in this action.

The NAO Report is essentially concerned with the events subsequent to the making of the railway administration order against Railtrack on 7 October 2001, and I anticipate that the main thrust of the PAC’s examination will focus on these issues. However, this litigation was referred to in the latest draft of the report seen by the Department, and so it is possible that the PAC might wish to explore the events leading up to and including the decision by the Secretary of State to petition the High Court for a railway administration order in respect of Railtrack plc. These matters are directly relevant to the subject matter of the litigation. It would not be surprising if Mr Rowlands were cross-examined on these matters at trial.
Although the proceedings in this action have only recently been issued, shareholder groups first threatened legal action against the Government within days of the administration order being made against Railtrack. Since then, there has been ongoing media interest, and the launch of the proceedings in December of last year attracted considerable press coverage. Now that the defence has been filed, we anticipate further interest and this is likely to continue intermittently until after the trial. The Department readily recognises that the public has a proper interest in the matters which will be the subject of the trial. But the Department is also entitled to a fair hearing. The risk to a fair trial can be created as much (if not more so) by press reports as by what is actually said in evidence before the PAC.

Accordingly I wish to explore with you all proper and appropriate avenues to try to ensure that a fair trial in this case is not prejudiced. There seem to me to be two principal issues to consider.

First, article 9 of the Bill of Rights affords protection to those giving evidence to a Select Committee from being subjected to a penalty, civil or criminal, in any court or tribunal for things said in the course of proceedings in Parliament. However, I understand that it is now common practice for the courts to have regard to statements made by Ministers and others in proceedings in Parliament when adjudicating upon an application for judicial review of a ministerial decision. Furthermore, the Joint Committee on Parliamentary Privilege of 30 March 1999 recommended that the exception of judicial review proceedings from the scope of article 9 should also apply to other proceedings in which a ministerial decision is material. The decision taken by the Secretary of State to petition for a railway administration order in respect of Railtrack plc is not just material to, but central to, the court action. It is therefore possible that the claimants in the action may attempt to use at trial any answers given by the Permanent Secretary to the Committee. However, since the Secretary of State’s decision is not central to the Committee’s consideration of the NAO Report, any answers he gives about the application for the railway administration order may give an incomplete picture of the whole process that led up to that decision. The claimants could attempt to take advantage of any omissions in the evidence before the Committee when they cross-examine at trial. In order to avoid that risk, the Permanent Secretary may need to give long and detailed explanations and in doing so may take up the Committee’s time unnecessarily on matters that are not central to its primary business. I would like to explore with you further how this might best be handled.

Secondly, the House of Commons resolution on “matters sub judice” of 15 November 2001 provides that, subject to the discretion of the Chair to the Committee, proceedings which are “active” in the United Kingdom courts are not to be referred to in any motion, debate or question. The proceedings in this case were issued on 2 December 2003, and the Department filed its defence on 3 March 2004. It is possible that the case management conference might take place before 26 May but, even if it does not, we are likely to have a date for it by then. If it has taken place, a timetable for the management of the case will have been set, and we will have been given dates between which the trial should take place. On present indications the trial is unlikely to take place before the beginning of next year. There is no reason for the Department to think that the claimants do not intend to proceed to trial and, as far as the Department is concerned, it intends to defend the action robustly. I should therefore like to explore further with you the application of the sub judice rule in circumstances such as this and, in particular, whether this would be regarded as an “active” case for the purposes of the rule.

Christopher Muttukuaru  
Legal Services Director  
19 April 2004

Supplementary memorandum submitted by the Department for Transport

Questions 158–159 (Mr Bacon):

Mr Bacon noted that Network Rail debt was around £12.8 billion and queried why Table 14 on page 30 of the NAO Report showed £9.19 billion. He asked whether further debt had been drawn since 31 March 2003 (the date given in the table).

As footnote 1 to Table 14 stated, the structure of the Strategic Rail Authority’s (SRA) support facilities has also changed since that date.

Below is an update to Table 14. This has been provided by the SRA. It shows the current structure of the SRA’s support facilities to Network Rail and the amounts drawn under these facilities.
Network Rail updated finance arrangements

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<th>SRA Facility</th>
<th>Total available (£ billion)</th>
<th>Amount drawn at April 2004 (£ billion)</th>
</tr>
</thead>
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<td>1.25</td>
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<tr>
<td>EIB/KfW</td>
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<td>Medium Term Loan Notes</td>
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<tr>
<td>Commercial Paper Programme</td>
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<td>Opco facility Tranche A</td>
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8 June 2004