House of Commons

Committee of Public Accounts

# Office of Rail Regulation: Regulating Network Rail's efficiency

## Forty-first Report of Session 2010–12

*Report, together with formal minutes, oral and written evidence*

*Ordered by the House of Commons to be printed 4 July 2011*

**HC 1036**
Published on 12 July 2011
by authority of the House of Commons
London: The Stationery Office Limited
£12.00

## Committee of Public Accounts

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### Committee staff

The current staff of the Committee is Philip Aylett (Clerk), Lori Verwaerde (Senior Committee Assistant), Ian Blair and Michelle Garratty (Committee Assistants) and Alex Paterson (Media Officer).

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# Contents

# Summary

The Office of Rail Regulation (the Regulator) is the independent economic and safety regulator of the rail industry in England, Scotland and Wales. The Regulator's duties include promoting economy and efficiency in the rail industry with much of its work focusing on Network Rail, the owner and monopoly provider of the national rail network, including track, signalling and stations.

Network Rail does not face normal commercial pressures from investors and lenders to improve efficiency as it is a not-for-dividend company without shareholders, financed by debt guaranteed by the Government. It is therefore the role of the Regulator to hold Network Rail to account for its performance and to incentivise it to become more efficient. To this end, the Regulator sets efficiency targets when it determines the limits on fees Network Rail can charge train operators for use of tracks, stations and depots. It can also impose financial penalties, although the usefulness of this sanction is questionable as, by taking money away from investment in the railways, its impact falls mainly on passengers.

The Department for Transport (the Department) acknowledged the finding of Sir Roy McNulty's recent review of the rail industry[1], that the rail industry continued to fail to achieve effective value for money. In the five years to 2008-09, Network Rail reported efficiency gains of 27%, missing the target set by the Regulator of 31%, a shortfall of £204m.

Overall we do not believe that the Regulator exerted sufficient pressure on Network Rail to improve its efficiency, and that there is an absence of effective sanctions for under-performance in the system. We were particularly concerned that the Regulator did not enforce a stronger link between performance and bonus payments to Network Rail's senior managers, leading to excessive bonus and performance payments being paid to senior executives.

The relationship between Network Rail, the Regulator and their advisors appears to us to be too cosy, with some companies hired by the Regulator to provide an independent view of Network Rail also providing advice to them. We question whether this serves the interest of independent review.

We believe Network Rail should be more accountable for its use of public money, and more transparent in its operations. In 2009-10, Network Rail received £3.7 billion in direct taxpayer support, yet it is not directly accountable to Parliament. The Comptroller and Auditor General should have full access to Network Rail so that Parliament can scrutinise Network Rail's value for money.

The Regulator estimates that the gap in efficiency between Network Rail and the most efficient European operators was 34% to 40% in 2008, a position of relative inefficiencies which has not improved since 2003. The reasons for the gap are not properly understood, although Network Rail told us that they believed the single overriding factor was the difficulty of access to the railways to carry out maintenance work, which reduced its

1 *Realising the Potential of GB Rail: Report of the Rail Value for Money Study* , May 2011

productivity and thereby increased its costs. The Regulator will need to conduct more detailed analysis to understand the reasons for the efficiency gap, and what can be done to address them. It is a concern to the committee that after 10 years in existence the Regulator has still not carried out this work.

As part of determining Network Rail's financial settlement, the Regulator takes into account the costs the company is likely to incur including the cost of inflation. In its last review in 2008, it made an assumption that Network Rail's operating costs would be 8% above inflation over a five year period. We found this to be over-generous, reducing the pressure on Network Rail to find efficiencies and reduce its costs.

Network Rail plans to reduce expenditure by about £1 billion on renewing tracks and replacing signalling over the five years to 2013-14. It is reliant on this reduction to meet most of its efficiency target. It intends to achieve this by a more selective approach to rail replacement, but there is considerable uncertainty over whether deferring this work is genuinely efficient or simply delaying costs for the future. Network Rail and the Regulator need to carry out further work to understand this, and to ensure that Network Rail is making real and sustainable efficiencies, which are safe.

Both punctuality and passenger safety have improved in recent years, with 91.3% of trains meeting the punctuality target in 2009-10, and we heard that the UK railway is amongst the safest in Europe. We agree with the Regulator that safety is paramount and must not be traded-off against other outcomes. But with growing demand for more trains, limited capacity and less maintenance, it is important that trade-offs between safety, efficiency, capacity and punctuality are made explicit.

Overall, the complex industry structure creates risks to value for money, with fragmentation, duplication of effort and misaligned incentives. This has been confirmed by Sir Roy McNulty's review. We welcome the Department's commitments to improve governance, transparency, and clarity of roles in the rail industry. We nevertheless would have expected the Department to have a clearer idea of the priorities and issues to be addressed at this stage. We look forward to the Department's response to Sir Roy McNulty's review, and will return to this issue when the Department decides on the changes required to improve efficiency.

On the basis of a report from the Comptroller and Auditor General[2] we took evidence from the Regulator, Network Rail and the Department.

2 C&AG's Report, *Office of Rail Regulation, Regulating Network Rail's efficiency*, Session 2010-11, HC 828

# Conclusions and recommendations

1. **The sanctions and incentives on Network Rail, in particular penalties and bonuses, have not been effective in driving the company's efficiency.** The McNulty review confirmed that achievable value for money savings have not been realised properly. The Department agreed that the industry needs to focus on this issue. The Regulator reported that Network Rail had made efficiency gains of 27% in the five years to 2008-09, which fell short of the 31% target, a shortfall of £204m. Network Rail is up to 40% less efficient than the most efficient European operators, and this relative gap has not narrowed over the period in question. We doubt whether the Regulator is able to exert sufficient pressure on Network Rail's performance and are concerned that the main sanction of fines is just taking money away from investment in the railways. The Regulator should put in place a more robust performance management system and the Department should review the Regulator's powers. As part of this, the Regulator's assessment of Network Rail's performance should directly inform the level of bonuses paid to its executives. The high level of performance pay and bonuses enjoyed by previous rail executives is simply unacceptable given their inability to meet the efficiency target.

2. **The Regulator's allowance for inflation in Network Rail's financial settlement is too generous, reducing the pressure to drive down costs.** The allowance of 8% above RPI for operating expenditure over a five year period was a broad brush assumption which did not take into account Network Rail's purchasing power in some markets, or its ability to control its own salary costs. It appeared to us ridiculously overgenerous and it also means that the inflationary risk lies with the Department rather than with Network Rail. The Regulator should adopt a more sophisticated and rigorous approach to setting inflation assumptions in its next financial settlement in 2013. In doing so, it should clearly demonstrate that it has taken account of National Rail's ability to control its costs.

3. **We are not convinced that the Regulator can distinguish between genuine efficiency savings and the deferral of work which simply increases costs in the future.** Network Rail plans to defer about £1 billion worth of renewals work, such as renewing tracks and replacing signalling, over the five years to 2013-14. Without doing so, it will not meet its efficiency target. The Regulator must work with Network Rail to obtain robust evidence, including data on track usage and condition, to enable it to judge whether deferring maintenance work on this scale is efficient, sustainable and safe. The Regulator should publish the evidence that supports its judgement.

4. **The reasons for the gap between Network Rail's efficiency and that of the most efficient European operators are not fully understood.** The Regulator's international benchmarking work was an important contribution to identifying the scale of the efficiency challenge for Network Rail in the five years to 2013-14. However it is disappointing that after 10 years' existence the Regulator still does not properly understand the reasons for the gap. The Regulator should improve its understanding of how much is attributable to different factors. The Regulator should

publish the results of this analysis in its next Periodic Review in 2013, setting out timescales and the extent to which it expects those factors can be addressed by Network Rail.

5. **Network Rail told us that punctuality could not be improved to 95% in five years' time without making trade-offs with efficiency and capacity.** Punctuality has improved in recent years, with 91.3% of trains meeting the target in 2009-10, and we heard that the UK railway is amongst the safest in Europe. We support the Regulator's view that in seeking to reduce costs, Network Rail must not compromise safety. The Department, in preparing for the next regulatory settlement in 2013, should publish what it realistically expects can be achieved in terms of efficiency, capacity and punctuality, noting how it has assessed the trade-offs between them.

6. **We are concerned there may be duplication between the organisations involved in reviewing Network Rail's efficiency and that the relationships between them may be too cosy.** The Department for Transport, the Regulator, 'Independent Reporters', Network Rail itself and other funders all have roles in reviewing Network Rail's efficiency. Independent Reporters are appointed jointly by Network Rail and the Regulator but may also perform other work for Network Rail, creating at worst a potential conflict of interest and at best too cosy a relationship between various players. There is a lack of clarity about who is being held to account and who is commissioning work. The Regulator should strengthen arrangements to guarantee the independence of its Reporters, and should work with the Department and other funders to agree a protocol to ensure that work to assess and review Network Rail's efficiency is not duplicated.

7. **The complex structure of the rail industry creates inefficiencies and risks to value for money.** Because of the way Network Rail is funded, any financial penalties the Regulator imposes are ultimately borne by taxpayers and passengers, rather than by private shareholders. The fragmented structure of the rail industry also contains inherent inefficiencies such as duplication of effort and conflicting incentives, leading to potential confrontation between the bodies involved. We welcome the Department's commitments to improve the governance and transparency of Network Rail, and to clarify roles in the rail industry more widely. We nevertheless would have expected the Department to have a clearer idea of the priorities and issues to be addressed at this stage. In its response to Sir Roy McNulty's review the Department should be absolutely explicit about how any structural changes it proposes will improve efficiency. We will return to this issue when the Department has made its decision.

8. **Despite the levels of public subsidy it receives, Network Rail is not directly accountable to Parliament.** The Department should provide the Comptroller and Auditor General with full access to Network Rail so that Parliament can scrutinise Network Rail's value for money.

9. **We believe that the Regulator should have full access to the direct agreements between Network Rail and funders.**

10. **The internal operations of Network Rail are not transparent.** We are concerned about Network Rail's use of 'compromise agreements' with departing employees, and that a review by the Regulator has been required to investigate the delayed disclosure by Network Rail of an issue regarding level crossing safety. We are concerned that Network Rail was not able to tell us the total value of compromise agreements it had entered into. The Department and the Regulator should ensure that Network Rail is subject to the same transparency requirements as public bodies, with full application of the provisions of the Freedom of Information Act.

11. **We are concerned at the financial impact of cable thefts on the rail system. The Department should address the issue urgently and provide us with a detailed action plan within six months.**

# 1 Setting and monitoring efficiency targets

1. The Regulator's main duty, in addition to its responsibility to ensure the safety of the railways, is to promote economy and efficiency in the rail industry. Despite this, the Department acknowledged that the McNulty review made it plain that the rail industry failed to achieve effective value for money.[3] The Department told us there have been huge improvements in performance, significant improvements in capacity, and continued and significant improvements in safety during the period in question, and are hopeful of improvements in value for money going forward. The Department attributed these achievements to the Regulator working alongside Network Rail, but stated that the Regulator should be delivering more.[4]

2. The Regulator must judge how efficient Network Rail is, and must incentivise it to improve. The Regulator sets efficiency targets for Network Rail when determining the limits on the fees Network Rail can charge train operating companies for use of its track, stations and depots. It does this through Periodic Reviews, the most recent of which was published in 2008 and determined charges for the five years to 2014 (the 'control period').[5] In making its judgement, the Regulator takes account of:

i. the outputs required of Network Rail (including network safety, asset condition, reliability, capability and capacity);

ii. the costs it is likely to incur (including inflation on the costs of its inputs) in achieving those outputs at current levels of efficiency and;

iii. the potential for improving levels of efficiency.[6]

3. The Regulator set Network Rail a target of improving its efficiency by 31 % in the five years to 2008-09. Network Rail fell short of this target, reporting efficiency gains of 27 %.[7] Most of this gain came in the first three years of the period, with only a 3 % gain in the last two years.[8] We are not convinced that the Regulator has applied sufficient pressure on Network Rail, or that the sanctions for under-performance available to it are effective.[9] Neither are we convinced of the strength of the current or prospective incentives on Network Rail to achieve the efficiency targets set by the Regulator.[10]

4. In forecasting the costs Network Rail was likely to incur, the Regulator made allowances for inflation. It made a separate inflation allowance for three main categories of cost: operating costs (such as signalling and the electricity to run trains); maintenance costs (to sustain the condition and capability of the rail infrastructure); and renewal costs (mainly

3 Q 165

4 Qq 286-288

5 C&AG's Report, paras 1.5 and 1.6

6 Qq 12, 24

7 C&AG's Report, para 2.5

8 Q 11

9 Qq 2-4, 6-10, 169, 286-288

10 Qq 37, 45, 264-267

capital projects where existing infrastructure needs to be replaced). For operating costs, the Regulator made a total allowance for inflation, in the five years to 2013-14, of 8.14 % above the Retail Price Index (RPI). The Regulator also made allowances of 6.55% above RPI for maintenance and 3.44% above RPI for renewals.[11] The Regulator noted that capital prices, such as construction costs, had indeed increased much more than retail prices in this period to date, and Network Rail pointed out that input costs such as energy were beyond its control.[12] Nevertheless, it is clearly not the case that Network Rail had no control whatsoever over its input costs. The largest inflation allowance was for salary costs, over which Network Rail has complete control, rather than for energy or materials.[13] The unacceptably high allowance for costs above inflation has given Network Rail unnecessary flexibility, as well as reducing the pressure on Network Rail to drive down these costs. Given these arrangements, it is the Department which bears the impact of cost inflation as it has to live within a budget set in nominal terms. We believe the onus should properly fall on Network Rail to manage some if not all the inflationary pressures.[14]

5. In assessing efficiency, the Regulator considers Network Rail's performance and its costs. It takes into account both annual trends and performance relative to the levels agreed in the Periodic Review. The Regulator allows reductions in levels of Network Rail activity (such as the volume of track or signalling renewed) to count towards its efficiency target, providing that this reduced activity does not compromise delivery of required outputs, long-term asset condition or serviceability of the network.[15] However the Regulator admitted it had difficulty in distinguishing between work which can be deferred without increasing long term costs (genuine efficiencies) and deferrals which simply increase costs in the future.[16] Network Rail told us that it needed to develop better ways to analyse factors such as the condition of its assets, track replacement rate and steel quality.[17] In the five years to 2013-14, Network Rail hoped to defer £1 billion of renewals work in order to meet its efficiency target. It believed it would be able to use its knowledge of the condition of the network to convince the Regulator that it could defer work in a way that was effective.[18]

6. To compensate for the lack of domestic comparators, the Regulator told us it used innovative international benchmarking to compare the efficiency of Network Rail's spending on maintenance and renewals with that of rail infrastructure managers in 11 other European countries. On the basis of this analysis, the Regulator estimated that in 2008, Network Rail was 34 to 40 % less efficient than the most efficient European operators.[19] Network Rail told us that it believed this figure should be treated with caution,

11 Q 16

12 Qq 17, 20, 28

13 Q 21

14 Qq 24, 273-277

15 C&AG's Report, para 4.8

16 Q 78; C&AG's Report, paras 2.6, 4.10 and 4.11

17 Qq 74-78

18 Q 74

19 C&AG's Report, paras 4.17 and 4.19

and that its own analysis showed it was in the middle of the range of performance across Europe.[20]

7. The Regulator and Network Rail gave possible reasons for this efficiency gap relative to other European countries.[21] The Regulator told us that the main reason was the longer time taken to start work after a maintenance team had taken possession of a stretch of line. In European railways that could be minutes, but for Network Rail it could often be an hour or so. A typical possession might therefore yield only three or four hours of working time in the UK, compared to much longer working times in Europe. Such delays reduced productivity and meant higher costs overall.[22] Network Rail had done its own analysis based on comparing three bridge projects priced by the UK, the Netherlands and France. The UK price was 30% higher than France and the Netherlands, and Network Rail attributed this to the relative difficulty of gaining access to the railway in the UK.[23]

8. Network Rail suggested the following factors were also likely to contribute to the gap between its own efficiency and that of the most efficient European operators:[24]

i. Operating systems – The UK has 800 signal boxes, on average about 80 years old, but these could be replaced with 14. This would take 10-15 years to implement but could save at least £150 million a year.

ii. A lower level of electrification on the UK network – Electrified networks are cheaper to operate than non-electrified networks. Other European networks operate with around 70-80% electrification, with the UK closer to 50%.

iii. Tracks are replaced more frequently in the UK compared to Europe – This contributes to the UK's good safety record.

iv. The scale of approval processes and checks for capital projects in the UK adds time and cost.

9. We note these as compelling reasons for Network Rail's comparative inefficiency, but it is not evident to us that they fully explain the estimated efficiency gap.[25] Network Rail itself, for example, recognised that it needed to do more work to establish why it replaced its rails more frequently than France.[26]

10. Network Rail told us that demands to drive down maintenance costs, run more trains, and improve punctuality mean that there had to be trade-offs.[27] Reliability has improved in recent years, from 78% of trains meeting the punctuality target in 2001-02 to 91.5% in 2009-10.[28] Network Rail felt that achieving punctuality of 95%, for example, would be very

20 Q 37

21 Qq 46-48; C&AG's Report, para 4.22,

22 Q 47

23 Q 48

24 Qq 48, 51

25 Q 49

26 Q 76

27 Q 91

28 C&AG's Report, para 2.10

optimistic, and that the biggest potential gain for passengers would be made by increasing capacity.[29] Network Rail told us that there had been substantial improvements in train safety over the last 10 years, including a dramatic reduction in the occurrence of broken rails, and that the UK railway is amongst the safest in Europe.[30] It recognised that it had to balance safety and maintenance costs and prioritise high risk areas, such as the West Coast and East Coast mainline services which it classed as high risk, high speed lines.[31] The Regulator stressed that safety was paramount and could not be traded-off against other outcomes.[32]

11. We also heard evidence that £16.5 million was lost by Network Rail in 2010-11 alone through cable theft.[33]

29 Q 93

30 Q 79

31 Qq 80-81

32 Q 83

33 Ev 33

# 2 Industry structure and governance

12. Network Rail is a company, but it does not have shareholders or pay dividends. It described itself to us as neither a private company nor a publicly owned asset.[34] The company is financed mainly through debt raised from the capital markets, backed by government guarantees.[35] In 2009-10, about two thirds (£3.7 billion) of its £5.8 billion income came from direct taxpayer support.[36] However, Network Rail has no accountability to shareholders, nor does the National Audit Office have full access, so Network Rail is not directly accountable to Parliament.[37] It is our view that the Comptroller and Auditor General should have full access to Network Rail. The Department told us it would support making available some more granular information, although there was a further discussion to be had about access to full information.[38]

13. Network Rail operates in a unique and complex environment. The Regulator and Network Rail emphasised they had to find a way to work within the existing structure, and the Department indicated it wished to avoid change which required legislation.[39] However, the Regulator admitted that the incentives on Network Rail to improve efficiency needed strengthening.[40] The Department also acknowledged that regulation can fail to have traction in this environment, and confirmed that the Secretary of State is looking at ways to create a governance structure that strengthens accountability.[41] We believe that the Regulator should have full access to the direct agreements between Network Rail and funders. These agreements include major infrastructure projects such as Thameslink and CrossRail.

14. Network Rail believed it was possible to run an efficient organisation in the current environment.[42] However it recognised that fragmentation across the industry, which it characterised as a series of silos that have to talk to each other, carried with it some inefficiency. Network Rail stated that some of the current arrangements it has with the various train and freight operating companies are too confrontational, and would like the opportunity to implement a more flexible approach.[43] In particular all the witnesses acknowledged that incentives could be better aligned to promote greater cooperation between train operators and Network Rail, for example in gaining and granting access to

34 Q 41

35 Qq 210-215, 224

36 Q 209; C&AG's Report, para 1.2-1.4,

37 Q 37

38 Qq 216-217

39 Q 248

40 Q 45

41 Q 180

42 Q 42

43 Qq 57, 98, 170

the track for maintenance work.[44] We were not, however, convinced that changing the system on a local, patchwork basis would be effective.[45]

15. In the past, the Regulator has not been able to exert sufficient influence on the level of bonuses paid by Network Rail to its senior managers.[46] In 2009, the Regulator expressed its surprise at the level of bonuses paid to Network Rail executives considering that Network Rail had failed to meet its efficiency target, for the control period ending March 2009, by £204m.[47] Network Rail told us it had an overall bonus pot of £70 million covering 35,000 staff. In the last six months, it had reviewed its management incentive plan and had reduced the maximum annual incentive payment from 100% of salary down to 60% of salary.[48] The Regulator and Department recognised the need to strengthen the link between performance and decisions on bonuses, with the Regulator stating that there had been differences of opinion with Network Rail about remuneration in the past.[49] However differences of opinion do not appear to have been effective in cutting the performance and bonus payments made under the previous Chief Executive. The Regulator has tightened up the process by establishing three high level objectives that the incentive plan must meet to ensure that the bonuses support delivery of Network Rail's obligations in a sustainable way. The Regulator confirmed that if Network Rail did not deliver on these agreed objectives, any bonuses it then paid would not be valid.[50]

16. There are a number of bodies with some involvement in reviewing Network Rail's efficiency. These include Network Rail itself, the Regulator, 'Independent Reporters', the Department for Transport, and other funders. This gives rise to potential duplication of effort and inefficiency. The Regulator reviews Network Rail's efficiency at its Periodic Reviews, and monitors efficiency during the period covered by each Review.[51]

17. To assist its Periodic Reviews, the Regulator appoints four 'Independent Reporters', jointly with Network Rail, to provide assessments of the completeness, accuracy and reliability of information supplied by Network Rail.[52] These 'Independent Reporters' are typically consultancy firms which give a second opinion to the Regulator on specialist topics. We were concerned that the relationships between Network Rail, the Regulator and their advisors may not be sufficiently independent, particularly given that some of the 'Independent Reporters' also perform other work for Network Rail.[53] Both Network Rail and the Regulator argued that the joint appointment of 'Independent Reporters' was more efficient and effective than each party appointing its own consultants.[54]

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44 Q 57

45 Qq 264, 267

46 Q 33

47 C&AG's Report, para 3.12

48 Qq 116-117

49 Qq 35, 238

50 Qq 64-66

51 C&AG's Report, para 4.2

52 C&AG's Report, para 4.3

53 Qq 127-135

54 Qq 140, 147

18. The Regulator does not regulate the entire rail industry. The Department, which is responsible for setting overall requirements from the industry, also awards franchise agreements to passenger train operating companies, oversees train operators' performance, and sets limits for regulated fare increases.[55] The McNulty review recommends a single regulator for the whole industry, and the Department agreed that it would be appropriate to move towards such an arrangement over time. The Department also accepted that there should be more clarity between its role and that of the Regulator.[56] The Department agreed that it should concentrate more on its strategic role, rather than being dragged down into the detail, and admitted that this would be a major change.[57] It was disturbing to find confusion between the Treasury and the Department of Transport as to the nature of the indemnity given by Government in respect of Network Rail's debt.[58]

19. Network Rail commissioned an inquiry from Antony White QC into allegations of financial impropriety, which reported on 24 May 2011.[59] Among other things, the inquiry considered the probity of a number of 'compromise agreements' whereby departing Network Rail employees received a payment in exchange for agreeing they had no further claims against the company for any breach of its statutory obligations. The agreements being reviewed included provisions to prevent departing employees from disclosing certain information. The Regulator does not have sight of any such agreements, and told us it did not consider them a matter for the Regulator.[60] Evidence submitted to us by Network Rail after the hearing states that it had entered into 300 compromise agreements since 2006, but does not indicate how many contained a clause to prevent disclosure, nor does it set out the total value of such agreements.[61]

20. Pursuing the issue of transparency, we noted press reports of an internal Railtrack memorandum from 2001 regarding safety at the Elsenham level crossing, an issue which had not been made public until 2006. The matter is currently the subject of review by the Regulator, who will judge whether it was material to the public interest and was withheld deliberately.[62] Network Rail is not currently subject to Freedom of Information legislation, but told us that it would not object to being included within the scope of the Act in future.[63]

55 C&AG's Report, para 1.9

56 Q 284

57 Qq 285, 294-296

58 Qq 207- 215

59 *Report of an inquiry into allegations of misuse of public funds and serious financial impropriety within Network Rail*, Antony White Q.C. 23 May 2011

60 Q 109

61 Q 105

62 Qq 158-162

63 Q 113

# Formal Minutes

### Monday 4 July 2011

Rt Hon Margaret Hodge, in the Chair

Mr Richard Bacon
Mr Stephen Barclay
Dr. Stella Creasy
Matthew Hancock
Jo Johnson
Mrs Anne McGuire
Austin Mitchell
Nick Smith
Ian Swales
James Wharton

Draft Report (*Office of Rail Regulation: Regulating Network Rail's efficiency)* proposed by the Chair, brought up and read.

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

Paragraphs 1 to 20 read and agreed to.

Conclusions and recommendations 1 to 11 read and agreed to.

Summary read and agreed to.

*Resolved*, That the Report be the Forty-first Report of the Committee to the House.

*Ordered*, That the Chair make the Report to the House.

*Ordered*, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

Written evidence was ordered to be reported to the House for placing in the Library and Parliamentary Archives.

[Adjourned till Wednesday 6 July at 3.00pm

# Witnesses



# List of printed written evidence

# List of Reports from the Committee during the current Parliament

The reference number of the Government's response to each Report is printed in brackets after the HC printing number.

**Session 2010–12**

| | | |
|---|---|---|
| First Report | Support to incapacity benefits claimants through Pathways to Work | HC 404 |
| Second Report | Delivering Mulit-Role Tanker Aircraft Capability | HC 425 |
| Third Report | Tackling inequalities in life expectancy in areas with the worst health and deprivation | HC 470 |
| Fourth Report | Progress with VFM savings and lessons for cost reduction programmes | HC 440 |
| Fifth Report | Increasing Passenger Rail Capacity | HC 471 |
| Sixth Report | Cafcass's response to increased demand for its services | HC 439 |
| Seventh Report | Funding the development of renewable energy technologies | HC 538 |
| Eighth Report | Customer First Programme: Delivery of Student Finance | HC 424 |
| Ninth Report | Financing PFI projects in the credit crisis and the Treasury's response | HC 553 |
| Tenth Report | Managing the defence budget and estate | HC 503 |
| Eleventh Report | Community Care Grant | HC 573 |
| Twelfth Report | Central government's use of consultants and interims | HC 610 |
| Thirteenth Report | Department for International Development's bilateral support to primary education | HC 594 |
| Fourteenth Report | PFI in Housing and Hospitals | HC 631 |
| Fifteenth Report | Educating the next generation of scientists | HC 632 |
| Sixteenth Report | Ministry of Justice Financial Management | HC 574 |
| Seventeenth Report | The Academies Programme | HC 552 |
| Eighteenth Report | HM Revenue and Customs' 2009-10 Accounts | HC 502 |
| Nineteenth Report | M25 Private Finance Contract | HC 651 |
| Twentieth Report | Ofcom: the effectiveness of converged regulation | HC 688 |
| Twenty-First Report | The youth justice system in England and Wales: reducing offending by young people | HC 721 |
| Twenty-second Report | Excess Votes 2009-10 | HC 801 |
| Twenty-third Report | The Major Projects Report 2010 | HC 687 |

| | | |
|---|---|---|
| Twenty-fourth Report | Delivering the Cancer Reform Strategy | HC 667 |
| Twenty-fifth Report | Reducing errors in the benefit system | HC 668 |
| Twenty-sixth Report | Management of NHS hospital productivity | HC 741 |
| Twenty-seventh Report | HM Revenue and Customs: Managing civil tax investigations | HC 765 |
| Twenty-eighth Report | Accountability for Public Money | HC 740 |
| Twenty-ninth Report | The BBC's management of its Digital Media Initiative | HC 808 |
| Thirtieth Report | Management of the Typhoon project | HC 860 |
| Thirty-first Report | HM Treasury: The Asset Protection Scheme | HC 785 |
| Thirty-second Report | Maintaining financial stability of UK banks: update on the support schemes | HC 973 |
| Thirty-third Report | National Health Service Landscape Review | HC 764 |
| Thirty-fourth Report | Immigration: the Points Based System – Work Routes | HC 913 |
| Thirty-fifth Report | The procurement of consumables by National Health Service acute and Foundation Trusts | HC 875 |
| Thirty-seventh Report | Departmental Business Planning | HC 650 |
| Thirty-eighth Report | The impact of the 2007-08 changes to public service pensions | HC 833 |
| Thirty-ninth Report | Department for Transport: The InterCity East Coast Passenger Rail Franchise | HC 1035 |
| Fortieth Report | Information and Communications Technology in government | HC 1050 |
| Forty-first Report | Office of Rail Regulation: Regulating Network Rail's efficiency | HC 1036 |

# Oral evidence

## Taken before the Committee of Public Accounts

## on Wednesday 11 May 2011

Members present:

Rt Hon Margaret Hodge (Chair)

Matthew Hancock
Stephen Barclay
Joseph Johnson
Ian Swales
Mrs Anne McGuire
Austin Mitchell
Nick Smith

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**Amyas Morse**, Comptroller and Auditor General, and **Alex Scharaschkin**, Director, NAO gave evidence. **Gabrielle Cohen**, Assistant Auditor General, and **Marius Gallaher**, Alternate Treasury Officer of Accounts, NAO, were in attendance.

**REPORT BY THE COMPTROLLER AND AUDITOR GENERAL**

**Regulating Network Rail's Efficiency (HC 828)**

**Examination of Witnesses**

*Witnesses:* **Bill Emery**, Chief Executive, Office of Rail Regulation, and **David Higgins**, Chief Executive, Network Rail, gave evidence.

**Q1 Chair:** Right, apologies for starting a little late; that is my fault, but we will see how we go. Can I welcome Bill Emery back for what will be your last performance—
***Bill Emery:*** It will.

**Q2 Chair:**—before the Select Committee, and can I welcome David Higgins in his new role? I think lots of us have known you in your past role and appreciated your contribution with a number of hats on. Welcome for what will be your first appearance before the Public Accounts Committee. Can I just start straight away on the performance of Network Rail in relation to what the regulator wanted from you over the last spending period, over the last five years? You set a target of 31% efficiency gains; Network Rail only achieved 27%. The difference is about £1 billion, so it is a lot of money. Are you happy with that, Mr Emery?
***Bill Emery:*** No, I do not think we were happy with that at all, in the sense that Network Rail made very good progress in the early part of Control Period 3, and then basically had problems finding solutions to lowering the costs of renewals. Our stance was then to look at the position as was in the run-up to the next review and take account of that when setting the challenge for Network Rail for the control period we are in at the present time. Of course, we evidenced that with the innovative work we did on international benchmarking to establish the scope for improving efficiency when we set them the challenges for improving efficiency, and delivering the Government's requirements on punctuality, network availability, safety and, of course, the largest enhancement programme that the industry has had.

**Q3 Chair:** Are you happy with what you have inherited then, Mr Higgins?
***David Higgins:*** Yes, I think that is a very accurate description. While good progress was made in Control Period 3 which finished in 2009, clearly the cost savings we hoped to get were somewhat delayed, but that has been allowed for in the settlement for CP4, so we have to achieve higher than the CP4 settlement to account for that shortfalling.

**Q4 Chair:** And if they do not, Mr Emery? What is your sanction? It seems to me your only sanction is to fine, and that is not terribly sensible.
***Bill Emery:*** We hold Network Rail to deliver on all the outputs, and the critical thing for Network Rail is to deliver on all the obligations and punctuality, safety and all the—

**Q5 Chair:** So you do not really care if they do not deliver on value for money?
***Bill Emery:*** Oh, we certainly do care, because in fact, in a sense, we want Network Rail and the whole of the rail industry to become more successful.

**Q6 Chair:** So you care, but there is nothing you can do about it?
***Bill Emery:*** I think that we will certainly be pressurising Network Rail, through all we are doing, to drive them forward, and as we are looking at it today the performance of Network Rail is ahead of the profile that we were setting them.

**Q7 Chair:** How do you pressurise them?
***Bill Emery:*** We pressurise them through continuous international comparisons, which demonstrate where they are with their peers, monitoring their performance year on year and assessing how they are getting on, both in their broader—

**Q8 Chair:** And if they fail, as they have done in the past?

***Bill Emery:*** If they fail in terms of meeting the obligations then we will take regulatory action on the company.

**Q9 Chair:** What?
***Bill Emery:*** That is a whole range of things, and at the end of the day, where there has been a clear failure and we believe as a board that there is a need for them to learn those lessons and not do it again, then there is the penalty that Parliament has given us on fines.

**Q10 Chair:** But you have never exercised that. I said earlier on it seems to me to be rather a daft sanction because it is just taking public money away from investment in the railways. The one sanction you have you have never used, and it is a pretty daft one: what else have you got in your armoury?
***Bill Emery:*** I think the issue we have, of course, is the financial penalty, which we have used, and we have fined Network Rail several times during my term of office, and it has had a significant effect in improving the way Network Rail runs.
***Chair*:** But we are still—
***Bill Emery:*** It is certainly, in terms of the performance of the railways—putting this into perspective, we have a railway that is performing better than it ever has done, and—

**Q11 Chair:** Not relative to Europe. Let me just put some facts to you: if you look at page 15, figure 3, and you look at real expenditure over the period that we are examining your performance, 2004–5 total expenditure was—as I read that—£5.8 billion; by 2008–9 it had gone down to £5.5 billion, so it has hardly changed. It is pretty pathetic: it is 5% over five years. If you look at the European comparators, our relative position has not moved at all. If you look at what Network Rail did in those five years, they got a little bit, but it is not much, and we will come on to how you assessed efficiency savings in a minute. But they got it in the first three years, and they got only 3% on the basis on which you have assessed it in the last two years. All that, to me, looks pretty pathetic.
***Bill Emery:*** I think we take a different view on that, in the sense that following the obligations placed on Network Rail in the CP3 Settlement about restoring punctuality on the railways and putting the house in order, post-Railtrack in administration and Network Rail taking it over, they made a 27% improvement in efficiency, on our records, in that period. They did not make their 31%, and of course the costs within Network Rail were about the tasks that were placed upon it by the Government at the time, and in a sense, we go back to the issue that yes, we accept the railways need to become substantially more efficient, and that is a task that we have been hammering on with Network Rail for all my time, and we have set them a real test.
***Chair*:** I will just reiterate, it is 5%—5.8% to 5.5%—5% is actually the reduction in costs over a five-year period.

**Q12 Matthew Hancock:** I want to question this point about costs, because obviously the improvements in efficiency are made within a context of what happens to costs and input costs. So given changes in input cost, how do you take them into account when you are deciding how effective Network Rail have been in meeting the efficiency targets?
***Bill Emery:*** Clearly when you are setting up as a regulator the expected costs for Network Rail, or in my time when I was doing all this for the water industry, based on an improvement in efficiency, the costs fall out of both the improvement in efficiency and the challenge thrown down to the company to invest, to improve, to meet the Government requirements or whatever it is. You cannot make a direct parallel between the costs and the efficiency. With regards to input costs, you have a choice, as a regulator, whether you leave that risk with the regulated enterprise, so input costs could move in a different way than with the real Retail Price Index, or you can take a judgement on that, and you take a view as to how those costs are going to move over the five years of your settlement relative to the RPI and then, as you go year by year, you look at what has happened on input costs, you look at what they have done and what they have delivered, and your efficiency comes out of whether they have delivered and what, in their own cost terms, is happening, so it is quite a complicated process.

**Q13 Matthew Hancock:** So if input costs move against you that obviously makes it harder, but isn't Network Rail a pretty big buyer of the services of the inputs that it buys in the country?
***Bill Emery:*** It certainly is, and it is—

**Q14 Matthew Hancock:** So should it not have some ability to control its input costs?
***Bill Emery:*** It is then a matter of looking at which index you use, because the attempt is to find an index that reflects, in Network Rail's case, the movement in construction costs, or whatever it would be, and try to tease that out, and get a view on that.

**Q15 Matthew Hancock:** But that implies that those costs are outside Network Rail's control, but if, as you say, Network Rail is a big operator, surely getting those costs down is a big part of making their organisation more efficient?
***Bill Emery:*** And it could well be.

**Q16 Matthew Hancock:** But it hasn't been in the past, has it? In page 33, paragraph 4.23—I am just going to quote for a minute—"The Regulator has made allowances for input price inflation of 8.14% above retail price inflation for operating expenditure." That is an enormous rate of inflation that you have allowed them, despite the purchasing power they have.
***Bill Emery:*** In coming to that judgement, we are looking at—given all the challenges that we are facing in Network Rail—what the potential movements were.

**Q17 Matthew Hancock:** A potential movement of 8% above RPI?

***Bill Emery:*** Yes. If you look at the movement in capital prices relative to RPI, over the five year period, these things can rise that much.
***Chair*:** It is crazy.

**Q18 Matthew Hancock:** Why did Network Rail not ensure that its input inflation was lower than 8% above RPI?
**Chair:** Mr Higgins?
***David Higgins:*** I think firstly, do we control the industry and control the price? Absolutely not.

**Q19 Matthew Hancock:** I did not say "control the price", I said, "Did you have some control over it?"
***David Higgins:*** We would be 2% or 3% of the national market.

**Q20 Matthew Hancock:** So you are saying that you cannot drive down the costs of your inputs at all, despite the fact that—
***David Higgins:*** Efficiency. But the biggest input costs into all of delivery in construction is energy costs, because energy goes into everything: it goes into the manufacturing of steel, it goes into petrol, it goes into every single contractor's costs, so one of the best barometers to see what happens with underlying costs is to follow the price of oil, because that shows you what is going to happen. So yes, we have driven down costs during this period through effective buying, because you cannot fight energy costs or those escalating costs. Now, during that period of Control Period 3, we saw the price of steel sky-rocket.

**Q21 Chair:** But hang on a minute, just if I can come in on this, because I am interested in energy as the driver—I do not know what proportion, you can come back—but if you read the rest of that paragraph, this is operating expenditure, which I assume is mainly people, whereas maintenance expenditure, still shockingly, was 6.55% above RPI, so that is where you are buying stuff, and renewals—which is really where you are buying stuff driven by energy costs—was 3.44% above. The one area that is people, you are 8.14% above RPI.
***David Higgins:*** Let us deal with numbers. We agree with the numbers in the Report here, but if I can make it clear, when we exit Control Period 3—we are talking about Control Period 3 now—so when we exit Control Period 2, our figures, if you baseline them to today, are around £7.2 billion. If you look at those issues: opex is £1.3 billion; by the end of Control Period 3, it has gone from £1.3 billion to £995 million, so it has gone down about £320 million in real terms during that five-year period. That is the actual operating costs. You are absolutely right; a lot of the operating costs are wages and salary costs—

**Q22 Matthew Hancock:** Hold on, can I just hold you there, because you said "in real terms", and that is precisely my point: that this is deflating it—
***David Higgins:*** This was RPI—

**Q23 Matthew Hancock:** RPI, not whatever is allowed for the regulator, RPI plus, "Here you are, here is a bit extra."
***David Higgins:*** We have a settlement: this is discounted back at RPI, these figures I have here.

**Q24 Matthew Hancock:** So if I come back to the policy question: if, in the regulatory structure, you allow for increases in cost above inflation, and you explicitly set out that there are these costs that are allowed to rise, surely that takes the pressure off Network Rail and reduces the impact that you can have, because you are saying, "Do not worry about those costs, we know they are going to go up and we do not really care about them."
***Bill Emery:*** No, I think these indices are used to come to a view, as a regulator, of what is the likely expenditure this company is going to have to deal with over the five years; it is indexed against RPI as a starting point. These are a set of assumptions you make and you have a choice: if you impose those risks on input prices moving differently to RPI and make no adjustment for them, the answer will come out as, "I will have to increase the cost of capital on the company, because of the risk"—so you make a judgement.
But actually when you get into the period you have set an assumption there. Now the task is for Network Rail to manage that totality to deliver it, and do it at the least cost it can do. Those are just a series of assumptions that help to tease out what would be the most realistic expenditure level, and forecasting what is going to happen to a business that is investing in a lot of things that do not run with RPI, at the time of periodic review, and then recognising that what will happen will then be picked up in the next period.

**Q25 Matthew Hancock:** I understand that, but then if energy prices are a big part of it—of course, we have all seen the rise in energy prices—then would it not be more helpful, in terms of the incentives on the company, to break down the different risks within the cost input? We all accept that Network Rail, whilst a big buyer of railway kit in the UK, is a very small player in the global oil market. If you break down those different input costs, you could have a much more sophisticated system that would have a better impact on the incentives of the company that you are supposed to be trying to drive costs out of.
***Amyas Morse:*** That is a concern to me. Forgive me, I am not piling on, but it is relevant, and therefore if you do not mind if I just add this, both of you can answer at the same time, please. We commented on your model, and we gave full credit for the innovative features. Measuring efficiency here, with all of these inflationary factors, does depend on having very good unit cost information, and we were surprised how poor it was and how lacking it was in the growth that we expected to see now. Is it not true that if we are going to be able to talk on a level playing field and have a meaningful dialogue in the future about the way the industry is getting more efficient, we are going to have to improve our unit cost information considerably from where we are now? Is that your baseline intention, Mr Higgins?
***David Higgins:*** You are absolutely right. We need to work within a very tight budget, and CP3 and CP4, I said when I was a non-exec director—

**Chair:** CP3, CP4?
***David Higgins:*** Both of them in my mind are very tight. CP4 is a very tight set—
**Chair:** I'm sorry, CP is?
***David Higgins:*** Control period. Sorry, I am into the slang of the railway industry already—it is not a very good start, is it? I went through all the numbers of the Control Period 4 settlement, which goes from 2009 to 2014, when I first joined the board as a non-exec, and I thought it was very difficult to achieve, whether it be the public performance measures, the delayed minutes; all the measures, I thought, were very difficult to achieve, but everybody is very focussed and motivated to achieve it. So has Bill set a tough standard? I believe he has, and it is something we are working very hard to meet. Did we meet it last Control Period? The answer is no; we went close on a number of areas, and there were substantial improvements, but we missed that, but everyone is focused on achieving Control Period 4, and to answer your question, the only way we are going to achieve that is get away from high level figures: 30% or 40% less efficient, who knows, against what, and benchmark. You are right, we have a lot of information, because you could well ask, "What the hell are you talking about? What don't you know about the railways?" We have a massive amount of data, but we are working hard to make that better. Now, Bill and the RR have worked very closely with us to say we want more data on this now. We do a lot of accounts; we will look at out regulated financial statements in the next few weeks. I think there are something like 170 different schedules of information. But when you look at maintenance or operations, at the moment it is around 40% to 50% of the expenditure in both those areas where we do a detailed breakdown in a form that is easy to understand, and we are expecting both those areas to substantially improve within the next six months.
***Amyas Morse:*** That certainly needs to happen, doesn't it? Because the independent reporter's comment is that there are "continuing limitations in the quality of maintenance unit cost information and completeness of renewals unit cost information." What I think we are going to be looking for in future is a real plan to get to the point where we have this information.
***David Higgins:*** And we are very clear about that, and you are right: on maintenance at the moment we have very strong cost analysis on track renewal and on signalling, but we have not got the other areas, but we expect within a short period to have that much better level of granularity on that.
***Chair*:** I think we will all want to pursue the unit cost issue, but can you just deal with Matthew Hancock's point about looking at—although obviously unit costs will make it more sensible—a baseline for allowable inflation and then measuring performance efficiency; what do you feel about his comments on that?

**Q26 Matthew Hancock:** Having a more sophisticated assumption, given that some of the costs are controllable and some of them are less so.
***Bill Emery:*** This debate has run long and hard in all the time I have—

**Q27 Matthew Hancock:** Yes, and what is your view on it?
***Bill Emery:*** In the water industry, it is tackled by saying the water companies carry nearly everything apart from capital costs, and then the capital output price index is used, and essentially there is a central assumption made by the regulator, and then movement one way or another, and then there is an adjustment mechanism. The question is that works, and essentially, in some respects, that is a little bit like what we have got in railways. You just decide whereabouts you draw the line as to how much you want to put in the hands of the company to handle; you are still going to have to make a central assessment because you do not want to get, within the first period or year, it to be out from RPI and you are going to have to adjust. So you are going to have to make a central assumption; the question then is, is the risk of volatility on that so large that it cannot be managed within the risk buffer you set for the company. If it is, then you put in an adjustment mechanism; if it is not, you leave it as it is.

**Q28 Matthew Hancock:** Thank you, that was my question. The reason I ask for your view on it was because the answer to the broader question about, "Are you not giving too much leeway in terms of the cost increase that you are allowing?" the response was, "We have these big energy cost increases", and that makes it very clear that part of the costs are more controllable, and part of the costs are very hard to control. Would it not be better to have a regulatory framework in which there is a breakdown of some of those costs instead of an overall picture, so you are given the risk for the things that you can control, and do not have to shoulder the risks for the things you cannot control? Mr Emery?
***Bill Emery:*** I think that this comes down to the argument of how much you control the things. In most other sectors what the regulators are trying to do is not to create a complete insulated company where it is—
***Matthew Hancock*:** Absolutely, that is right, but**—**
***Bill Emery:*** And the judgement we have taken—and we have taken it after extensive consultation—on the balance between which way you go, in terms of how far you insulate a company from these things, looking at what types of risks they can manage, recognising that there might be upsides and downsides, and come to a balanced package. Our whole approach to setting the price limit is that we have to make a whole series of assumptions, we want to set a clear set of outputs, which is a really challenging set of outputs for Network Rail to deliver.

**Q29 Chair:** So, are you saying yes or no to Matthew's suggestion?
***Bill Emery:*** We are saying that we think we have struck the right balance in terms of—

**Q30 Chair:** You are saying you have got it right now
***Bill Emery:*** We got it right this time.
***Chair*:** You do not think there is anything else. Okay.

**Q31 Stephen Barclay:** I really just want to come back to the Chair's opening points about the ability to

pressure the company, because, Mr Emery, you seem to be contradicting yourself. You started by saying that yes, you feel you can exert pressure over Network Rail, and a moment ago you were saying, "Well, there is a limit to how much we can do, we do not want to insulate the company", and obviously if it had shareholders they would exert pressure; if it was subject to Parliament the NAO would have fully scrutiny. But it seems that you are doing neither one nor the other. Really, just a very basic question: how can you be exerting effective pressure if this company is 37% to 40% less efficient than European competitors?
***Bill Emery:*** I think the issue we were facing was do we look at widening the period in which we make comparisons with Network Rail, and we found, from our detailed work, that the arguments in previous peer reviews, that international comparisons were essentially debating points, were a credible useful approach. That has identified the gap, and we have set Network Rail's challenging determination. Now, for Network Rail, from our point of view, when we set a determination we set the level of revenue that Network Rail is getting that is consistent with an improving level of efficiency, and we set the outputs that are needed to deliver year on year.
***Chair*:** It would be really helpful, so that we are not sitting here all day, for you to just answer the question. If you cannot answer it, fine, but if you answer the questions we will move on to the next area of questioning.

**Q32 Stephen Barclay:** The fact that this Report is saying we are up to 40% less efficient than the best in Europe suggests that the pressure you have been exerting has not been effective, does it not?
***Bill Emery:*** I think the pressure we have been exerting has been quite effective in what they have delivered, but we have clearly identified that Network Rail, as it stands today, are in the middle of the pack with European railways, and we have set Network Rail the challenge, over this period and the early years of the next period, to take it up to the best in Europe.

**Q33 Stephen Barclay:** Let me give you an example, because bonuses have been widely reported as a contentious issue; it is an issue on which you might have been expected to exert pressure. In 2008, the regulator made no view; in 2009 it expressed its surprise and disappointment but was ignored; and in 2010 the firm decided that it was going to take a fundamentally different approach—a fundamental variance of approach—and now in 2011 it is currently under review. Nine years after Network Rail set up, it is still under review, there has been no crystallisation and you have been ignored to date. It does not really smack of a regulator that is exerting pressure.
***Bill Emery:*** That is not the way that we see it, although we do understand the amount of concern around management bonuses.

**Q34 Stephen Barclay:** How have you changed that? What has been the material output of the pressure you have exerted?
***Bill Emery:*** In the discussions leading up to this Control Period, we discussed with the remuneration committee of Network Rail what they were going to do to widen the scope of their management centre plan, which they did. I think we expressed our surprise and disappointment about the judgements that they took for the last two years.

**Q35 Chair:** Was it an abuse of the system?
***Bill Emery:*** There was a difference of opinion about the remuneration.

**Q36 Chair:** Was it a waste of taxpayers' money?
***Bill Emery:*** This is not a waste of taxpayers' money. We believe in management incentives. We believe that these can be a powerful tool.

**Q37 Stephen Barclay:** The management were ignoring you, so the management have disregarded your view. In my view, it comes back to the fundamental issue, which is that we have the wrong structure for Network Rail. We have this bizarre structure where there are 100 or so members, made up of a mix of train operating companies and members of the public. So there is no accountability to shareholders, nor does the NAO have full scrutiny, so it is not fully accountable to Parliament; your debt is underwritten by Government, and as a result you are not asserting effective pressure. Would the answer not be for us to look again at the actual structure of Network Rail?
***Chair*:** Mr Higgins, do you want to comment on any of this? The European comparison?
***David Higgins:*** Let me start with that. As we say in this Report, great care should be taken with the high level number of 40%, great care. What it shows is that today we are middle of the pack on European companies. A number of major European companies do not even contribute to that.

**Q38 Stephen Barclay:** We know your own data is flawed, so you are disputing the numbers, but your own data is flawed.
***David Higgins:*** What I am saying is that great care should be taken with a high level number of 40%. What we do agree with, however, is that substantial efficiency savings can be made, and if you look at the early drafts of the McNulty value-for-money report, what that flags up is that if we achieve what is set out in Control Period 4 and what we think can be achieved in Control Period 5 then we get to the top of European best practice. That is the target.

**Q39 Stephen Barclay:** But in year four and five of Control Period 3, what did you achieve?
***David Higgins:*** In year four and five of Control Period 3 there was some slippage.
***Stephen Barclay*:** What did you achieve?
***David Higgins:*** The numbers are in the Report, I can tell you—here we are.

**Q40 Stephen Barclay:** Because my reading of the Report was that you did fairly well in years one, two, three, but not in years four and five.

***David Higgins:*** That is right. In the final two years it did not achieve what was expected in the control settlement, that is right. So there was an under-achievement, so that is why there was the shortfall from 31% to 27%. Still, that is a substantial—

**Q41 Stephen Barclay:** Therefore, we cannot overly rely on what is going to happen in the future, which comes back to the point that the structure you have does not mean that you are getting shareholder pressure, nor are you getting full public scrutiny.
***David Higgins:*** You are right about the structure; the structure is in the middle: it is neither a private company nor a publicly owned asset. But it is interesting that what the Report says is that "Network Rail reports efficiency gains compared favourably with other regulated industries." You do not always have to be a private company to run businesses efficiently.

**Q42 Stephen Barclay:** I am not saying that you do.
***David Higgins:*** Of course, you do have the history of where this came from, so you can still run a very efficient and competent, heavily targeted organisation in this nearly unique structure that we have in Network Rail.

**Q43 Stephen Barclay:** It is your suggestion to the Committee that the structure we have at the moment is right, and as regulator, you think the existing structure gives you the necessary ability to put pressure on the company?
***David Higgins:*** On the structure, the structure is what we have; it is not my position to propose a different structure to this Committee or to the Government. It is the Government's decision; it has a White Paper further down the track. If it wants to change the structure, that is entirely the Government's decision.

**Q44 Stephen Barclay:** Have you had discussions with Ministers on that?
***David Higgins:*** No I have not. My job is to run this organisation as I see it, and to run it and deliver value for the public.

**Q45 Stephen Barclay:** Mr Emery, have you got the right structure?
***Bill Emery:*** As a regulator, we have the structure that was decided upon by Government and we regulate that structure. I agree with you, and we agree and we have set out that the incentives on Network Rail need strengthening. We wanted to move away from the financial indemnity, to make sure there was a hard budget constraint. We have worked quite hard to make sure that the members of Network Rail are properly informed of our performance. We are an independent regulator, who hold Network Rail to account, and from the perspective of reporting on its performance on a quarterly basis, we are reporting more intensely on Network Rail than occurs in any other regulated sector.
***Chair*:** Bits of paper do not necessarily make for good regulation would be my comment on that.

**Q46 Joseph Johnson:** Just a follow on from Mr Barclay's line of questioning. I am very struck by paragraph 4.22, which says that "the reasons for the efficiency gap" relative to other European countries "are not fully explained", or really do not seem to be understood. I am particularly alarmed by that. Could you give for me, please, Mr Emery, what you think are the three most important reasons why this efficiency gap exists?
***Bill Emery:*** The work we have done, when, of course, we went much further than just looking at the numbers and the econometrics, was to look at the practices, and the work that we exposed was that there were huge potential gains associated with how Network Rail did possessions to do work on the railways, when it took access to the railways and the time it spent on those. They do it differently elsewhere, and that leads to higher levels of productivity elsewhere. There are whole areas around the different ways that Network Rail manages its projects and its programmes, where its partners elsewhere in Europe have different ways of doing that—

**Q47 Joseph Johnson:** So the first reason I could not quite summarise, but the second reason I could just about get, which is bad project management at Network Rail. Could you just, in bullet point, explain what the first reason was again?
***Bill Emery:*** The first reason is that, when Network Rail does work on the railways, they take access to the railways. The time they take in that limited period to get access to the railways and then do the work on it and hand it back is different in Europe; in European railways, the time it takes to take access can be minutes. In Network Rail it can be an hour or so. So you have a six-hour possession, or an eight-hour possession. In Network Rail you might get three to four hours' work in that possession. You have to gear up all the resources to work on that four or five hours. If you go into European railways they can increase the working time. That has a huge impact on the productivity level, and essentially the work you can get done. That is possession management.

**Q48 Joseph Johnson:** Is this due principally to the separation of the ownership of the Network and the operating companies?
***Bill Emery:*** No, it has nothing to do with it.
***David Higgins:*** Can I have a go at answering that too? Firstly, one of the big differences in costs is operating systems. Our signal boxes are, on average, about 80 years old—which is great, but it is very historical—and if we can replace the current 800 signalling boxes, which we inherited through a very old legacy system and replace them with 14, which is what we should have, that would save £150 million plus a year. That would require at least a 10-to-15-year commitment to do that, but that is an obvious comparison.
Secondly, electrification: our network is dramatically less electrified than every other major European network: electrified networks there are more around 70% to 80%; we are closer to 50%. But fortunately we are now on a programme over the next decade to electrify more of the network. It is clear that an electrified network is cheaper to operate and more

effective. Even our existing network, of course, has a lot of use of a direct DC electrical system, which is up to 70 years old: it is a very old electrical system. That is the second one.

Thirdly, renewals: we renew our rails more often than Europe. That is really interesting; we have to ask why we do use our network more intensively. We do not have any high speed network: France has 2,000 kilometres; it will be 3,000 kilometres before we even open High Speed 2. So our wear and tear and maintenance means that we renew it more, we have more inspections, we have a higher inspection rate. But that means we have, I think, the lowest—certainly one of the lowest—rate of broken rails, which from a safety point of view gives us one of the best safety records in the whole of Europe.

Finally on to projects, which I think is a really interesting thing, because the only way we are going to get the costs down in the railways is to drill into what the costs are. What we did was take three projects, three bridges, actually designed bridges, UK bridges. We gave them to three international companies and a quantity surveying company based in France. The report has gone to Infrastructure UK and also to the ORR. We gave it to France, Holland and the UK, and we said, "Price these individual projects and work out what they were", and sure enough, guess what? It turns out the UK was 30% higher than France and the Netherlands. The reason why is that labour rates were cheaper; materials cost, except aggregate, were on par, but aggregate was substantially higher. Of course we tax it substantially, we have an extraction tax dramatically higher than France, for example. But the single overriding factor why working on the railways and those three projects, in their factual reports, is much more expensive is because of access to the railway, which is Bill's point. So a UK contractor is expected to use 30% of the time that French contractors would use and 10% of the Dutch time. So that means that we had to do the work that they would do in one tenth, in one third of the time, and guess what? The other reason is the French, as they move on to the railways, do not pay a penalty for going onto the railways. Now, last year we paid £180 million worth of penalties to access our railway to repair it and maintain it with train operating companies.

**Q49 Joseph Johnson:** Those are compelling answers that you have given. Are they sufficient, though, to explain why, for example, the NAO records that UK civil engineering work costs not 30% more than European companies but 60% more?
***David Higgins:*** UK civil engineering?

**Q50 Joseph Johnson:** That is the cost of UK civil engineering on the rail network.
***David Higgins:*** This Report showed that these projects on the surface were 30% higher in the UK, and when we had adjusted it they came out between 5% and 10% less than their European counterparts.

**Q51 Joseph Johnson:** Paragraph 4.23 suggests that "UK civil engineering works costs some 60% more than in Germany."
***David Higgins:*** All I would say is you need to do the level of analysis and reports. What I would say, however, is that there is absolutely no doubt that in delivering capital projects to the railway there are substantial improvements that can be made. What the other thing our study showed is that our design time here is substantially longer than Europe, because we have an enormous number of hoops to go through. There are a lot of approval processes, checkings, various and multiple standards. It takes much longer and it is certainly more expensive. There is no doubt that substantial savings can be carried out on our capital projects.

**Q52 Joseph Johnson:** That are within your control?
***David Higgins:*** Correct.

**Q53 Joseph Johnson:** Okay. Lastly, looking around the European landscape, what are the governance structures that really impress both of you as potential models as we go forward for Network Rail? To Mr Emery first and then to Mr Higgins.
***Bill Emery:*** The vast majority of infrastructure managers in Europe are essentially state-run companies and Government Departments, and I am not certain that they present a long-term solution here to where we have got to.

**Q54 Chair:** And the regulation structure?
***Bill Emery:*** There is minimal regulation: we are the largest regulator within Europe, and we are the only one that is a combined safety and economic regulator, precisely because the structure that Governments have decided is to privatise the railways, and the train operators need access rights, and established medium-term—
**Chair:** And Mr Higgins
***David Higgins:*** When British Rail was split up, it split up into over 100 different companies; so a very fragmented approach. Europe did not have that, so Bill is absolutely right. A lot of them look very much like what BR was, although there is now a separation between infrastructure and operations, which is an EU requirement. I have only been here three months, but I have already had a number of visits from European operators, from European rail companies, saying, "We need to understand how it works over here; the level of scrutiny, regulation and disclosure is substantially higher than what we are used to. We want to learn how you cope with this."
***Amyas Morse:*** I was listening with interest to what you were saying, and you were making all these points about the differences between Europe and the UK rail system, and I know you believe that. So that would argue that using a European comparative does not make sense for regulation, wouldn't it, and if that was true, what would you use instead? Supposing you were the regulator rather than the person operating it, how would you put a really tight vice around performance here?
***David Higgins:*** What I would be asking of Network Rail would be a lot more details. It is no use giving a high level figure: I want to know what your track renewal is on a mile-by-mile basis, I want to know how you do it and I want to be able to compare that, I

want to understand the stages of your capital projects, which is exactly what Bill is doing, and he has written to us and we have been doing this over the last few years. We are getting better: there is much more information out there. We have a lot of data; we do not have the information in the final form yet, but we will get there rapidly. That is the only way we can then challenge these issues, because I am quite confident there are big areas we need to challenge with our own internally applied standards, our approval process, our procurement, and the other thing that I think is that the only way we will get better efficiency on the railways is to open this up to competition. I believe in competitive pressure and contestability in everything we do.

**Q55 Chair:** What, the infrastructure?
***David Higgins:*** Yes, I believe in competitive pressure to drive efficiency. There is no use in what I do inside our organisation to encourage people to do things fast and quicker, but if I say, "Well, I am going to take this design"—we use a grip process,—"at this stage, and then I am going to put it out to competitive bid and see if someone else can do that cheaper", then that way I can drive down prices, or at least I know what the outside market can do.

**Q56 Ian Swales:** Can I just ask if either of you see any irony in the discussion we are having? The European operators seem to be able to do all of this cheaper, that the infrastructure companies there tend to be state-owned, but there is an immediate response from Mr Emery saying, "Of course that would not work here." Do you see any irony in that, and that we are now rushing off saying, "Of course, it has to be privatised"? Is that actually part of the problem, if things are more efficient and cost-effective in Europe?
***David Higgins:*** I do not think I said we had to privatise to achieve that.

**Q57 Ian Swales:** I am putting together the various comments. We had a discussion about efficiency and cost, and the National Audit Office Report talks about the difference with the continent. Mr Johnson then asked about governance, and Mr Emery said that most of these companies—most of the equivalent organisations in continental Europe—are state-run. We have been having that discussion. I was just saying: do you not see some irony in the fact that we are now saying automatically that this has to be privatised and that competition is the answer? Should we be advising the Government that there is actually another way here?
***David Higgins:*** I think what we would say is that there is no doubt that fragmentation brings some level of inefficiency, because you have a series of silos that have to talk to each other, and perhaps are too fragmented, and we need to get closer alliances. Some of the current arrangements we have between how we operate and the various train and freight operating companies are too confrontational and could be changed to align incentives, and I think could bring, for example, access to the track. You could change the current system to get greater cooperation on that, which I think would benefit us all. But Europe is moving to our direction. It is moving to much greater disclosure. There are going to be pan-European infrastructure companies that will look like Network Rail but will be across Europe in time, and you are going to have to separate operations from infrastructure. That is coming whether state-owned companies like it or not, but that is where the future is going. In many ways the UK has led Europe in this process, but it has been challenging.

**Q58 Mrs McGuire:** Are you of the opinion that we are still trying to deal with some of the issues—I will use that term advisedly—around a rather speedy and somewhat botched privatisation when the railways were privatised in the mid-90s?
***David Higgins:*** I do not think I can comment on that because I was not around here at the time.

**Q59 Mrs McGuire:** I am not asking you to comment: I am asking you to think about some of the answers that you have given now. Do you think some of them might relate back to the way in which the railways were privatised in the mid-90s? We have gone from 100 companies, which you have mentioned, to all sorts of different configurations for our infrastructure.
***David Higgins:*** Yes, but what we have had, which is interesting—sooner or later you have to challenge an industry and bring in competition. So yes, there have been challenges and some hiccups in the process; the odd contractor has not survived in that process, and I think it was a very traumatic period for the industry in the late 1990s and early 2000s—it was a very, very difficult period. But it has come through it, and what the private sector and the train operating companies and the freight operating companies—freight is a fantastic example because, with the competition that is on the freight industry, there was huge elevation of getting more competition between incumbent freight operators in the market. If you look at the innovation that the various train operators have brought to marketing and tickets—I travel regularly on the Virgin route up there; you can hardly get a seat on it nowadays, it is so popular—

**Q60 Mrs McGuire:** Where do you mean? Up where?
***David Higgins:*** I was in Manchester yesterday.
***Mrs McGuire*:** Right, up North, sorry. I always like to have people's perceptions of the country. Right, sorry, Manchester, up there.
***David Higgins:*** Is that the right direction?
***Mrs McGuire*:** It depends which end of the country you are looking at it from.
***David Higgins:*** All I am saying is that there are many benefits that have come from bringing in the private sector and innovation. You look at the way Chiltern Railways have run their operation, their innovation in delivering capital projects: all that is good stuff. But the only way we are going to make the next level of efficiency gains is to have more and more benchmarking and competitive pressures within our organisation, and contestability.

**Q61 Mrs McGuire:** And do you think that the only way to do that is to open it up to greater

competitiveness? Benchmarking does not necessarily need to be opened up to greater competitiveness.
***David Higgins:*** You need both, but when I say opening up to competition, we, Network Rail, are a monopolistic supplier to ourselves, so that is interesting. Parts of our organisations are incredibly skilful, and some of the best engineering expertise I have, and some parts we do not have to do, because the industry—our supply chain, the designers and contractors in this country—are very sophisticated, and they can do work that we can do, and we need to challenge whether they can deliver that more cost-effectively.

**Q62 Mrs McGuire:** And Europe is looking at our model in many respects and quite likes it?
***David Higgins:*** Europe, yes; we met one delegation—there is another one coming next week—who were over here just looking at the level of disclosure, which they find amazing. The information out there, and they are trying to understand how a regulator works and how they deal with a regulator on that issue there. But we can learn a lot from them.

**Q63 Mrs McGuire:** I will finish on this: does that not give you some confidence that while the model can be improved, that actually, essentially, it is working?
***David Higgins:*** I am not here today to ask for change. I have been given this job to run Network Rail more efficiently. There are more efficiencies to be achieved; we can achieve Control Period 4. It will be hard work, but we have got to do that. We need to set tough measures for Control Period 5, and that is about to start. But the way we are going to achieve it is through greater granularity, much greater transparency on what we do; payment for performance and not payment when we do not perform; that is clear as well. But we can achieve it in this structure. We should not make any excuse and say the structure is why we are not performing. That is just a cheap excuse from our point of view.
***Mrs McGuire*:** I agree with you on that.

**Q64 Austin Mitchell:** It is nice to know that Europe is looking at us with some interest, after 20 years of thinking we are barmy. I just want to revert back to the point that Bill Emery made, because your machine of discipline seems to be only, on the one hand, to use a nuclear weapon, which is a fine, which you do not want to use, or to wring your hands and say, “You’ve been naughty”. Would it not be better if you bumped them in the bonuses: if you had some control over remuneration and bonuses? Because this is a unique company, as Stephen Barclay brought out: it is a nationalised entity as well, and it is a monopoly. So don’t you think you need more power?
***Bill Emery:*** I do not think we need more power. I think what we have done recently is, in the light of Network Rail’s non-executive directors looking at their management incentive plan, we have established three high level objectives that that plan must comply with, and those are licence objectives, and they are that the bonuses should and must support sustainable delivery on Network Rail’s obligations, so there is a requirement and there is a tightening-up, but that is the basis.

**Q65 Austin Mitchell:** Are you happy that they do a scale of bonuses up to 60% of annual salary?
***Bill Emery:*** The new scheme of bonuses that Network Rail are talking about at the moment has to comply with those things, and if Network Rail deliver on those then there is real benefit to passengers, freight customers and taxpayers.

**Q66 Austin Mitchell:** And do you need a section for if they don’t deliver?
***Bill Emery:*** And if they don’t deliver, then under the objectives we have set the actual bonuses would not be valid because they would breach the licence obligations that we have now imposed upon Network Rail that this plan has to comply with. In a sense, we have got to that position because, in some respects, the discretion that was available to Network Rail’s remuneration committee we did not think was exercised effectively. We think this is a means of tightening that up, which is what we have done.

**Q67 Austin Mitchell:** I think you are believing a little in the efficacy of prayer. Let me move on. Paragraph 2.6 on page 17 says that, “The Regulator’s assessment of 2.8% efficiency savings in 2009–10”; the achievement is “slightly below its expectation”, which was 3.8%. But you cannot tell how much of that is due to the difficulty of distinguishing between deferral of renewal activity and genuine efficiency. If you cannot measure it, how can you control it? You can fiddle the figures, in other words.
***Bill Emery:*** We do not fiddle the figures.

**Q68 Austin Mitchell:** No, but they can by deferring.
***Bill Emery:*** There has been a considerable debate, which we have got to tease out, which is when Network Rail do not carry out the work that they had planned—and in the first year they were having to review their asset policies where there was not a clarity as to exactly what they needed to do—as to whether that deferral is a real deferral, which is of benefit, because they do not need to do it, or whether or not they are going catch it up over the five years.

**Q69 Chair:** Mr Emery, do you know how much of their so-called 23% efficiency gains was deferral and how much was renewal? Do you know? Does the regulator know?
***Bill Emery:*** Which 23% are we talking about?

**Q70 Chair:** Over the time—sorry, I got the wrong figure, the figure that you actually achieved, which was—I cannot remember now—27%; of the 27%, how much of that was deferral?
***David Higgins:*** I can answer that: in Control Period 3, my understanding is there was no efficiency in renewals achieved by deferral. In Control Period 4 there is some allowed for, but the best description on at the top of page 16, which says that “an efficiency saving is a reduction in cost relative to a pre-defined baseline level which does not compromise the sustainable achievement of the outputs required of the

regulated company". That is the key. If we can avoid replacing rail, because we do not have to, if we can get life extension that save public money, and we absolutely should be doing it, but we cannot do it at the expense of the asset condition or public safety, and remember, there is no incentive—

**Q71 Chair:** Okay, I understand that. So if I go back to the thing Austin Mitchell drew our attention to on paragraph 2.6, I am assuming it is Control Period 3 that it is referring to here, and it is saying that, as far as the NAO is concerned, in looking at your claimed savings, or the ORR's claimed savings in that period, there was difficulty in distinguishing deferral and renewal.
***Bill Emery:*** There was difficulty.

**Q72 Chair:** But you are saying that there was not.
***Bill Emery:*** This is talking about 2009–10.

**Q73 Chair:** Which is Control Period 4, is it?
***David Higgins:*** No, sorry, this is Control Period 4, yes.
***Bill Emery:*** This is the first year of the Control Period, where we were trying to make an assessment of the efficiency—

**Q74 Chair:** So can you tell me for 2009–10? I understand that you have to meet you safety obligations, etc. In 2009–10, how much of your efficiency was genuine and was not due to deferral?
***David Higgins:*** When we are talking about genuine, this is all about having a decent asset condition. In the bad old days of the early 2000s, you just replaced railway because you had 400 speed restrictions on the track at any one time. That was demand-led. A more and more sophisticated approach to monitoring of the rail, monitoring its performance, allows us to spend less public money, so in Control Period 4 we would hope to be able to defer, in order to meet our figures, over the whole five years about £1 billion worth of renewal in order for us to hit this number. That is how we get some of our savings; it is not the majority of our savings in renewals, but we hope to be able to defer that, because we have a better knowledge of the asset condition, and we can convince the regulator that we are doing that in a way that is effective.

**Q75 Chair:** But it is not an efficiency saving.
***David Higgins:*** No, it is not doing the work faster or cheaper, but it is smarter.

**Q76 Chair:** But it is not: it is deferring.
***David Higgins:*** No, it is not deferring it. We already know in Europe that we replace our tracks more regularly than France does. So why do we do that? Is it just because are very conservative? Or is it because of the quality of our steel? I do not know. We need to, and we will do, more work.

**Q77 Chair:** But the assessment you are making is that the £1 billion you can defer you can do without—your assertion is that we are conservative and we spend too much on renewals.
***David Higgins:*** No, to get to our Control Period 4 numbers, we assume we need to be able to get asset extensions—
***Chair*:** I understand that, but the task you have been set is an efficiency task.

**Q78 Austin Mitchell:** Is the NAO therefore wrong in saying, as it says in paragraph 2.6, "There is, however, a more general difficulty in obtaining information to identify genuine efficiency", and in saying, in paragraph 4.10, "It can be difficult to distinguish between scope efficiency and deferrals." Is it wrong?
***David Higgins:*** No, that is right, it is difficult, but the answer to that is you get more and more sophisticated asset models. You need to understand more and more about your track and the quality of everything that you are doing to get those answers.

**Q79 Nick Smith:** On track, it is interesting in your comparison with France, where you said they treat, or they replace their track less often than us. Early on, you said that we monitored our track better, and we had good safety records. What are the comparative figures on safety for our track here compared to the French track?
***David Higgins:*** One of the best measures is broken rails that occur. That is a rail safety issue. If a rail breaks, a train can be derailed: that is unfortunately tragically the reason for some of the disastrous train crashes over a decade ago, so our standard on broken rails has now come from, if you look at 10 years ago, around 900 happened in a year; we are now down to around 100 to 170 I think this year we are going for. So they have come down dramatically. Then, in terms of safety standards, we are the second safest railway in Europe of all those railways, both at track worker level, but also from a passenger point of view. In the 10-year period there have been substantial improvements of British train safety compared to where we were.

**Q80 Nick Smith:** What is the trade-off between track safety and reducing maintenance costs here? Are they two separate things?
***David Higgins:*** No, they are linked, but there is a judgement there. We could do fewer inspections on a track to match Europe, but the risk then is that you may miss broken rails, because track inspections are how you find out on the ground broken rails for drivers of trains, and if that happened too much we would get an increase in broken rails, and then we run the risk—

**Q81 Nick Smith:** So have you got it right now?
***David Higgins:*** It is always a balance, and the way we can do this is you have to work out where the high risk areas are to replace rail: so high speed networks, West Coast, East Coast Mainline. These are high risk, high speed lines.

**Q82 Nick Smith:** So are the French doing that better than us at present?
***David Higgins:*** The French have 2,000 kilometres of brand new high speed line—90% of high-speed

journeys in France, long distance, go on the high speed network.

**Q83 Nick Smith:** What is their safety record, compared to us?
***David Higgins:*** They are further up the scale in terms of the European stats—i.e. they are not as safe as ours—along with Germany, and Sweden is the one that is ahead of ours.
***Bill Emery:*** From our point of view, safety is paramount in the railways, and in our terms it is a value, and it is not to be traded off in those terms. It is a challenge for Network Rail and it is a challenge for all the rail operators to find a better way of doing things that do not lead you to increased safety risk, and the driver is to manage that risk, and find the ways in which they can do things better, do it differently, save money, but not actually sacrifice any of the really sensible safety gains that have been made in our railways.

**Q84 Nick Smith:** And how do you we compare internationally on that issue?
***Bill Emery:*** On those issues, we are a very safe railway in this country and that is a lot to be proud of, and there is lot in the industry to be proud of what the industry—

**Q85 Nick Smith:** So it is worth paying for good maintenance and regular replacement of track?
***Bill Emery:*** The industry has got to do the right amount of maintenance, but it is a matter of how you do it and whether or not you are doing it on the right assets at the right time, and the question really has to be what information you base that on.

**Q86 Ian Swales:** I would like to come on to another area of efficiency that is mentioned in the Report. When I walk into my local mainline station, Darlington, I see a screen where the railway prides itself on hitting a target of reliability of 86%, and what that means is that 86% of the time I am going to get on that train, and it will only be 10 minutes late or less, which is a further 7% on top of my journey, and if I get it at York it is about 10% of the journey. To me, those do not feel like particularly ambitious targets, compared with other business activities or services. I am just wondering, if you look at the graph on figure 6, indeed, the reliability has been increasing dramatically and it looks like the whole network is over 90% now—which means, for some reason, the East Coast mainline seems to be lower down the scale—but what I want to know is what you feel about how ambitious these targets are, what the future holds and also, importantly, Network Rail's role in this reliability figure, because obviously if an engine breaks down then that is not to do with Network Rail, but if you are doing maintenance unexpectedly or something, then that is. I wonder to what extent you analyse these figures. Let's remember that this aspect of efficiency is what most impacts on passengers, unlike the costing we have been talking about before.
***Bill Emery:*** Clearly, I think the industry has come on a long way from the dark days at the beginning of this millennium, and, as you say, on average they have achieved their best ever results at the end of this year. But—and there is a big but—whether that is the right measure long term is an issue that need to be teased out as part and parcel of the Government's high level output for the railways, and that is part and parcel of the periodic review that we are going to be triggering in the next week or so and the discussions around that. Passenger Focus have done recent work on this as to how much people value punctuality and basically their satisfaction on these things. That depends on what market you are going to; whether it is a commuter market or a business market, whatever it is, they have different values on these types of things, and that means that there may well be a need for a slightly more sophisticated approach now that you have got out of what was a pretty poor position and you are into a little bit more sophistication. In terms of delivering punctuality, then this is, essentially, a really collaborative effort between the train operators and Network Rail to work together at root level, and in a sense the mechanism we have, our joint performance improvement plans. We are looking at what is needed to meet our requirements we put on Network Rail, which are based on the Government requirements; how does Network Rail make sure it improves its delay minutes, and how does the train operator deal with that? Where there are issues—and you are right to mention that there are issues on the East Coast—that is when there is more intense scrutiny from the regulator, and that is one of the issues that we have more high up on our regulator escalator, to push Network Rail and the train operators to find solutions to sort this out, because it is not acceptable.

**Q87 Chair:** Mr Higgins, do you want to answer the question?
***David Higgins:*** Sure: you are absolutely right on East Coast. The challenge on East Coast is the trains are 35 years old, the signalling system is 40 years old—so all past the use-by date. We are not going to do any major upgrades on East Coast for at least five to seven years; there are interim patches—something at Hitchen and a few other areas—with large sections that are two-track, so that when something goes wrong it goes horribly wrong. It is very difficult to divert. We allow, over a year-period, for delays that may happen. We forecast cable theft, and we used up six months of allowance in cable theft in one month last month: it all happened. Let's hope for the next five months we get nothing, but that is highly unlikely so that causes huge disruption. So theft of all the signalling system shuts the system down straight away. It is a really challenging line, because it is really at its limit and we are putting another 19 paths on it in the next few weeks, which is going to put even more pressure on a difficult line, and it is a line that has got a lot of users, including heavy freight.
We are going to commit to a major freight loop that will divert freight off the line. It will take us the next three years to upgrade an existing line through Peterborough. This is a line we put a huge amount of focus in, and only before I came to this meeting I was looking at all the incidents that occurred in the last week; I watched the incidents and all of the delays. But I think we can better coordinate control; because,

when everything was split up it did have separate controls of track and operators, I think on East Coast we can do more to make that coordinated, and I think we can do better at the mainline stations, because when an incident happens the public are very frustrated and they do not know what the hell is going on, and I think there is a lot of work we can do on that in particular at King's Cross.

**Q88 Ian Swales:** Just as a rider to that—admittedly this is a very small data sample—but having travelled by train in both Western and Eastern Europe, you can set your watch by the time the train sets off and by the time it arrives. We seem to have a culture where we accept that if it is 10 minutes late that is okay. Well, is it? It does not feel okay as a passenger. To me, I always feel—and obviously coming here I am a very regular rail user—there is an attitude issue, that people do not feel there is an urgency, that it is a real failure to be five minutes late, and it is. If you promise to do something and you fail to do it, you have failed, and you do not get the impression that people even consider that as any sort of an issue. I will respect that we regard 10 minutes as okay, but even if it is 15 minutes, you do not sense from any of the people involved, in the stations or on the trains, or anybody, that there is a problem, that is just okay.

***David Higgins:*** There is a huge focus on that, and the historic way, and the way still today, to deal with that is called right time. The way you fix that up is when you have a problem on the network you cancel that train, you will cut it short and you will take the passengers off the train, and you explain to them that the train they expected to occur is no longer going to come, and you restart the timetable, and then the timetable gets back on track. That is the right thing to do. It is very difficult, though, if you are a train operator and you want to keep your customers on the trains, and you have a different incentive, so we have a different incentive than the train operators: we are targeted on delay minutes, they are targeted on public performance measure, primarily. So that is a real discipline. The pendulum has probably gone too far on leaving the trains going and delaying in stations, with the volume that is getting on a train nowadays means that trains leave stations late, and therefore it delays it. We probably need to be more disciplined in terms of getting the timetables back to schedule.

**Q89 Chair:** I just want to go on to the North East a bit, because we heard the evidence yesterday, and it is one of the advantages of doing it. I have to say, looking a year or two back, it is the deterioration in the last year, so I think some of your explanations are interesting; they do not really convince me about why there was such a deterioration in performance over the last year. The other thing is, on the North East, we had the evidence there: 60% of the delay there—according to the NAO—is attributable to your work. Only 40% was the operator. So taking a train out would have not have made a difference. So you are sitting here and saying that, but it does not sound 100% plausible.

***David Higgins:*** You are right: the 60/40 is correct, and track asset failure is a big part of it. Every now and again, like the external events at Grantham recently, and the odd tragedy in terms of suicide on that line does that, but a lot of it is just failure on the infrastructure.

**Q90 Chair:** Which has got worse in the last year.

***David Higgins:*** It has got better in the last three months, because I track every single metric on that line, so it is turning round.

**Q91 Ian Swales:** I am just interested, as a former manager of things myself, we are at 92%: where is that line going to be? What can passengers expect of our system?

***David Higgins:*** In my opinion, you are going to get to the law of diminishing returns on this network, because you have three things you want to do: you want us, rightfully, to drive down maintenance costs; you want to have more trains on time, and you want more trains on the same track. All that doesn't work: something has to blow. There has to be a fine line of that on there. So you think of a simple line, like the Brighton line; it is just a straight line there. You shove more and more trains on that track, it will wear out the track quicker, you will have less and less time to maintain it, and therefore the cost will go up.

**Q92 Chair:** There are other options; you can have longer trains and get on with extending the platforms, which was an issue that we looked at about three months ago.

***David Higgins:*** And we're doing that. You are correct, you are absolutely right.

**Q93 Ian Swales:** So you think what, about 95%, is about the figure that, if we look in five years' time, is our aspiration?

***David Higgins:*** I think that is very optimistic, 95%. I think the biggest thing we can do is focus on capacity, and in next control period, when we finish Crossrail and Thameslink, particularly in the London commuter market, that will deliver a 30% increase in capacity, which will be the biggest increase in capacity this country has had for probably 100 years.

**Q94 Austin Mitchell:** If the East Coast line is that bad, why is it not going to be upgraded for five years?

***David Higgins:*** West Coast costs £9 billion to upgrade it.

**Q95 Austin Mitchell:** The civilised part of the Committee all travels East Coast.

***David Higgins:*** That is right. We are doing some interventions on East Coast. The problem for East Coast is it was built much later than West Coast, of course, and therefore it had longer capacity, it was electrified 30, 40 years ago, unfortunately in a way that was not that sustainable, but that is what it is. Therefore it was never as bad as West Coast, and therefore it has been put off. It does need a massive upgrade, but its major upgrade is probably Control Period 6 or 7 to do that in.

***Bill Emery:*** I would just go back and say these issues on what is the right level of punctuality, what are the right metrics, where to put the investment and enhancement of the railways are things that are going to be teased out over the next 12 to 18 months as first of all the industry put its—

**Chair:** Can we have really tight answers so I can get on?

***Bill Emery:*** It is going to be into the industry and then down to the Government in its high level specification for the railways, both here and the Government in Scotland, in 2012—and there is going to be a widespread consultation—and what we are wanting from the industry and David and all his colleagues is to have good information on the options and trade-offs so there can be an informed debate around these things and choices can be made, because it is trade-offs.

**Q96 Austin Mitchell:** David Higgins said that electrification was more efficient, but most of the failures I have experienced on East Coast have been because the trains come off the wires and it has held up the whole system. It is either that or Geordies pinching the signal wire, which is fairly common as well.

***David Higgins:*** You are absolutely right, and you know why: because when it was electrified the things that hold up the wires were set too far apart.

**Q97 Austin Mitchell:** You're joking; is that right?

***David Higgins:*** Yes, that's right. And so what happens is the wire swings in the breeze, and it comes off the top of the trains. It is as blunt as that, unfortunately.

***Austin Mitchell*:** And we are putting all our sympathy into London, and here are we suffering.

**Q98 Nick Smith:** Two quick points from me. First of all, this theme of international comparisons. Mr Higgins, I am grateful that you are going to improve your project management and you are going to use your data better; that is music to the ears of this Committee, and good that Europeans are coming over here to hear about your best practice. Earlier on, however, you said that there were still recurring industry problems, in particular with fragmentation of operators and confrontation. How are you going to reduce the costs of those quite tricky issues?

***David Higgins:*** They are tricky, and I think the great opportunity is the refranchising. That is just starting now, West Coast is the first one to come out in the next few weeks, and then over a period of five to seven years nearly every major line gets refranchised for a train operating company. For passengers, there is logic in what they call Schedule 4 and Schedule 8, which are the access penalties you need to pay for unplanned events or planned events, but they do not align us. There are 600 people on both sides of Network Rail and all the train operating companies that work out how much we can claim from each other. So it is an industry. It was interesting how it was put in at the start, but surely that needs to change. We need to be able to say there are times when we can access the railway that will save us money, that will not hurt train operating companies that much to lose that time, but they will only give it up if they get some benefit from the savings we are going to get. We need to explore those and experiment, and the challenge is that there is not one size that fits all. Each of the regions has their own specific issues, so we need to take a flexible approach, we need to be creative with the various train operating companies, we need to encourage them, when they bid for the franchises, to come back with options where they can save them money and ourselves money, and we will be very responsive to that.

***Bill Emery:*** That is something that we fully endorse. It has been a frustration for us as the regulator.

**Q99 Nick Smith:** Obviously it is a recurring theme. I was quite interested in this business about cable theft. It is a big issue on the Cardiff to Ebbw Vale line in the South Wales valleys, and you talked about using up your six-month budget in one month's budget. What are you doing about this? I know it is a problem in South Wales.

***David Higgins:*** We are working very closely with British Transport Police. Two days ago, we had a very big PR campaign to alert people to them. We have used infrared, for example, on some of our stations. On one of our stations, we prosecuted 40 different people until they worked out there were infrared cameras there. But the way to stop it ultimately is to stop the secondary market; someone is buying all this cable. That is the problem. There needs to be a marking, or there needs to be a tougher clampdown on people, the second-hand market, that is obviously buying railway cabling.

**Q100 Nick Smith:** How much is that theft costing you this year?

***David Higgins:*** I have not got the figure to hand, but I can tell you it is very substantial. The problem is, particularly with something like East Coast, when you lose that line it is just hopeless to try to recover the performance measure for the day, because when it goes down on such a long line it has a dramatic effect on public performance measures. It just knocks on.

**Q101 Nick Smith:** Can we have a note on how much it is costing?

***David Higgins:*** I will send you that.

**Q102 Stephen Barclay:** Could you just update the Committee on Anthony White's investigation, please?[1]

***David Higgins:*** Absolutely; it is still ongoing. I am not directly involved myself at all, my Chair is. I believe my Chair spoke to the QC running it, and is hoping to have something done by AGM, which is July of this year. So we are hoping to have that report through.

**Q103 Stephen Barclay:** Because I wrote to Network Rail on 5 January, and a press report said it would be a speedy reply; we are not going to get anything until July?

***David Higgins:*** I think it is June at the earliest, but certainly we would really like it before our AGM with our members.

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1 A copy of Antony White QC's Report on Financial Impropriety and Misuse of Public Funds by Network Rail has been placed in the House of Commons Library.

**Q104 Stephen Barclay:** And I was told the terms of reference would commit you to communicating the findings publically. Will you be making Mr White's report public in full?
***David Higgins:*** Yes. Personally it is out of my hands. I am speaking for the Chairman, but I know that certainly he has been given access to whatever information he needs.

**Q105 Stephen Barclay:** Okay, thank you. Flowing from that, one of the things I was very concerned to read about, and it is an issue that we have had before on the Committee, is compromise agreements and the number that Network Rail seem to have entered. Could you just confirm how many compromise agreements have been entered by Network Rail, and whether the regulator has full sight of those?
***David Higgins:*** I do not know how many compromise agreements offhand. I can certainly write to you and cover that[2].
**Chair:** Can we just ask for the information in a week?

**Q106 Stephen Barclay:** Mr Emery, do you see all compromise agreements?
***Bill Emery:*** We see no compromise agreements.

**Q107 Stephen Barclay:** You don't, as regulator?
***Bill Emery:*** As regulator we do not. These are matters for Network Rail and how to manage its staff.

**Q108 Stephen Barclay:** So in terms of the pressure that you were referring to that you exert on the company earlier, does it not concern you if public funds are being used to pay compromise agreements with gagging clauses attached and they are not notified to the regulator?
***Bill Emery:*** I think that the way we come at it is that public funds are there to deliver the railways that the Government want, and that is a whole series of outputs in the sustainable railway, and that is what—

**Q109 Chair:** You do not think this is an issue of public importance?
***Bill Emery:*** We think it is an issue that in fact Network Rail and members need to tease out, but I do not think it is a matter for the regulator.
***Chair*:** But you do not think the public should be able to follow that—

**Q110 Stephen Barclay:** I asked you whether it concerned you; I was actually asking for your personal view, which you did not give, but if one looks at the health service, we had quite a battle with Sir David Nicholson because all foundation trust compromise agreements have to be reported to the Treasury, and there was a reluctance to disclose those. They have since been disclosed. Are compromise agreements by Network Rail disclosed to anyone outside the company? In other words, to the Treasury, to the Department for Transport or to the regulator?
***David Higgins:*** Not that I am aware of. However, I think we are forgetting, in this entire discussion today, the board of Network Rail. We have a big change in the board, with a new chair and a whole new section of eight non-exec directors who come from very reputable backgrounds and they run a very tight ship. We run extensive reviews of everything that is going on in our organisation.

**Q111 Stephen Barclay:** Mr Higgins, I would not suggest that members of hospital boards are not reputable, but I am sure you would agree that most of the funds for Network Rail are coming from the taxpayer or from the public in terms of fares, and so it is not unreasonable to expect either the Treasury or the Department for Transport or the regulator to have sight of compromise agreements. Moving forward, would you be willing to the Committee an undertaking that all compromise agreements will be disclosed to one of those three parties?
***David Higgins:*** Can I come back on that?

**Q112 Stephen Barclay:** Sure. Okay, could I ask a related question then, because another area of transparency might be around freedom of information, which again, the structure of Network Rail means you are not subject to. Mr Emery, as the regulator, would you have any objection to Network Rail being subject to freedom-of-information legislation?
***Bill Emery:*** No, but from our perspective we have all the information that we need from Network Rail because we have an ability to get it.

**Q113 Stephen Barclay:** Sure, but even something as material as paying a compromise agreement of up to half a million pounds, and press reports suggesting that Network Rail had paid something like 150 compromise agreements, so obviously that was not material information for you, so what I am saying is that members of the public may be interested in using freedom of information. You would not have any objections to that?
***Bill Emery:*** I have no objection to that.
***David Higgins:*** Neither do I, as I have been on record at the Transport Select Committee. I have been used to FOI in the last two jobs I have had.

**Q114 Stephen Barclay:** Good, that is good to hear. Bonuses are linked into those issues. Could you just confirm to the Committee what the bonus pot is this year, and what percentage of salary is the maximum amount that can be paid in bonuses?
***David Higgins:*** This year there are no bonuses to the directors of the company. That has been an agreement reached with bonuses, set those aside; so nothing.

**Q115 Stephen Barclay:** So no members of staff will get a bonus at Network Rail.
***David Higgins:*** No, the entire organisation is on bonus, right to the—

**Q116 Stephen Barclay:** My question was what the bonus pot was, please.
***David Higgins:*** The overall bonus pot for the company is something like £70 million for the entire—
***Stephen Barclay*:** £70 million, okay.
***David Higgins:*** But that covers 35,000 people.

[2] *Note by witness*: Network Rail has entered into 300 compromise agreements since 2006.

**Q117 Stephen Barclay:** Sure; it was a simple question, I was just wondering what the bonus pot was. My constituents are paying more in fares, so obviously they are interested to know what the bonuses are, so what the bonus pot is, and what is the maximum percentage of salary that can be paid as a bonus?
***David Higgins:*** It was 100%, but we have reduced it to 60%. What has happened in the last six months is that we have reduced the annual incentive from 100% down to 60%; we have proposed tougher hurdles, and we have proposed deferring the annual long-term incentive to the end of the Control Period. What that has done is it has made the bonus pot much less attractive and much harder to achieve for the management team in Network Rail.

**Q118 Chair:** Can I come in on some structural issues? If you look at page 27, you have para 4.3 looking at your costs information. You have Network Rail—presumably you are trying to improve the quality of your data, as you have told the Comptroller and Auditor General—you have the regulator, you have the Department—I would be interested to know what, because the Department gives you grant direct, so presumably they monitor and ask for information arising out of that. We then have these sudden four independent reporters—I cannot quite understand why we need them too, and I would like to know who they are—and then we have the NAO that does the audit and the value-for-money work. It just seems to me, there are a heck of a lot of agencies and individuals seeking information, and I would like to know from both of you—
***Amyas Morse:*** We do not audit Network Rail.
***Chair*:** Of course, you don't audit—absolutely right. You audit the regulator; absolutely right, apologies for that. But it seems a heck of a lot, so I would like to know what the Department does in particular; I would like to know whether you justify all this; I would like to know who on earth the four independent reporters are and how you justify that.
***Bill Emery:*** I will explain the proposal. We have established a whole series of information requirements on Network Rail to hold it to account, and we get those regular flows of information month by month, and report quarterly in our monitor. The Department gets similar information.

**Q119 Chair:** The same information, do they?
***Bill Emery:*** It is not duplicated, although they get more financial information on the performance of the company.

**Q120 Chair:** What do they get that you do not get?
***Bill Emery:*** We are not certain that they would get the financial returns; you submit them both to us and to the—

**Q121 Chair:** So they get the same information?
***David Higgins:*** What the regulator requires are regulated financial statements, which the Department does not need. They have our management accounts, so there are just two complete sets of accounts. One is for the regulator, and they can both have both. There is no shortage of information, it is just that the regulator—consistent with all other regulators—have a set form of how they want their schedules—

**Q122 Chair:** And does the Department monitor those accounts and ask you questions about it?
***David Higgins:*** Absolutely, yes.

**Q123 Chair:** All the time. So you have both the regulator and the Department, then you have these independent reporters.
***David Higgins:*** And we have our board, and our board meets as four sub-committees, and this week, for example, I have two of those meetings, so in any particular month I will have three sub-committees meeting plus a main board, usually, of Network Rail, so it is extensive—

**Q124 Chair:** I assume you need one outsider; come back to me on what are the four independent reporters, who are they?
***Bill Emery:*** The independent reporters are, we have Arup, who are looking to give us an independent view on the robustness of the information Network Rail is providing to us and audit that information and carry out studies, and they are the ones that carried out—

**Q125 Chair:** Why can't you do that in-house?
***Bill Emery:*** What we found useful is that—as a regulator—is to seek a second opinion on these—

**Q126 Chair:** Why?
***Bill Emery:*** Because to our purposes that means that we are in a position that we can look at this independent opinion with Network Rail, because these are jointly appointed people with a duty of care to both of us.

**Q127 Stephen Barclay:** You just said they are independent; can I just check none of the four consultancy firms providing independent reports do other work for Network Rail?
***David Higgins:*** Parts of them probably would.

**Q128 Chair:** Arup will.
***David Higgins:*** Arup would, yes. We hire nearly every consultant—

**Q129 Stephen Barclay:** So we have consultants of firms providing independent reporters who also do other work for Network Rail and who are jointly appointed by Network Rail. How are they 100% independent?
***Bill Emery:*** Let me take me take you back a bit, because the history of independent reporting—in a sense it came from the model of consultant—

**Q130 Stephen Barclay:** The previous model may have been wrong. My question is that today, now, this is the arrangement under Mr Emery that is in place today; how are those independent reporters 100% independent?
***Bill Emery:*** They are independent, as professional integrity is the driver to independence. Their roles, including Arup on information, is constrained as they

cannot operate in those type of spheres in Network Rail. AMCL, who are experts in asset management, review that, and test Network Rail's approach on asset management—

**Q131 Chair:** And do they work for you in other ways?
***David Higgins:*** Not that I am aware of.

**Q132 Chair:** Okay, so one does, one does not.
***Bill Emery:*** We have Halcrow and Nichols on enhancement projects for us, and assist us when we are looking at—

**Q133 Chair:** And do they work for you?
***David Higgins:*** Nichols did one report for us I remember, yes—

**Q134 Chair:** And Halcrow—I've never heard of any—are these engineering companies?
***David Higgins:*** Halcrow is an engineering—these are multi-disciplined organisations.

**Q135 Chair:** And do they work for both of you?
***David Higgins:*** Arup I know would do some structural design for us. In the end, with £3 billion of capital projects at any one time, Arup would be somewhere working on one of those projects. But these companies have divisions, individual divisions.

**Q136 Chair:** I just want to raise two issues: firstly, why we need independent reporters—we have you; I do not understand why you do not have the in-house capabilities, and therefore there is a question mark about why we need the regulator if the regulator has to have other consultants' advice. Secondly, it feels a bit cosy, if we take Arup as the example. So you have this cosy little group of people in this industry; have you got anyone from Arup on your board?
***David Higgins:*** No.

**Q137 Chair:** Well, that is a delight.
***David Higgins:*** That is a shortcoming, and I will have to sort that out.

**Q138 Chair:** Your board is full of people in the industry too. It all feels very in-house, and then when you step back from it and you see the relative costs of us against Europe you think all these cosy relationships are not the best infrastructure for allowing you to drive down costs.
***David Higgins:*** It does not feel cosy from my point of view, I can assure you. Of those four organisations, what they do have is they have specialist knowledge, and what I want to know—and I do not believe organisations of the calibre of an Arup or a Halcrow are going to throw a report, because in the end their reputation would be trashed. Those organisations—and Arup did an excellent report on asset management; it came up with a lot of reports—so in 15 reports from each of those reporters over two years for £2 million in total, I think that is money well spent from those organisations. From our point of view, they have certainly given us reports that have caused us—

**Q139 Ian Swales:** Can I just ask Mr Emery, how many people are in your organisation as regulator?
***Bill Emery:*** Our organisation is 290 people, of which about 60% are on the safety side and the others are on the economic side, both looking at access and holding Network Rail to account.

**Q140 Ian Swales:** Correct me if I am wrong, but are we talking about reporters here that work for you, or do they work for Network Rail? Are they actually part of your regulatory function?
***Bill Emery:*** They are an imposition of the regulator. They exist because of the regulation model. They came from the approach before reporters of, when a regulator was seeking expert third party advice, they appointed a consultant. The company then appointed a consultant, and we had two sets of consultants writing reports. The model that was developed said, "We want a third party view on this, because we are going to have to take a judgement as a regulator about what we are going to do, and we will get a third party and we will give them a clear role to stand outside the two of us and use their professional integrity", and that is the way it has worked, and it has worked remarkably well.

**Q141 Chair:** It feels barmy, and it does not feel like good value for money that you need—and the Department, we have not come to the Department. I bet the Department has over 100 people working on this stuff.
***David Higgins:*** It being a normal company, the non-exec directors of Network Rail would have an audit programme, which would involve external consultants that would come in and audit parts of the organisation. We do not do that.

**Q142 Chair:** You must have auditors.
***David Higgins:*** We do. We have our internal audit team, but we have Pricewaterhouse that audit the—

**Q143 Chair:** So there is another lot; I have forgotten about them.
***David Higgins:*** They are financial auditors.

**Q144 Ian Swales:** I suppose in your 200-odd people, you mentioned the safety experts. Presumably you have staffed your organisation with people who know a bit about railways.
***Bill Emery:*** We have a considerable amount of experience in railways.

**Q145 Ian Swales:** I do not know what they do all day, but are they not capable of doing this?
***Bill Emery:*** There is always a choice when there is an issue and, if you looked at our regulator escalator, we have 27 things that we are discussing, whether or not we use in-house resources to carry out that, or whether we ask the reporters to do that. In a sense that is a choice you make: you are trying to tailor whether or not to buy in resources or to staff up. Just as David is saying the critical decision he has on competition is whether to do it in-house is exactly the same decision as a regulator. There is an advantage of having a reporting model: it is that you get an independent view

on the quality of the data that both of us can look at and then we can judge what the regulator response should be, and we can have a debate.

**Q146 Ian Swales:** Just on the theme of the Chair; it was interesting what Mr Higgins said about, “We find these reports useful and if we were a private company we would be calling these kind of people in”, which does not feel like the regulator sending in the dogs, somehow, does it? It seems more like—well, I do not know what it seems like. I think as the Chair said, there seems to be a lack of clarity about who really is being held to account and who is commissioning the work.
***David Higgins:*** They are jointly commissioned and report through to our audit committee, independent external directors.

**Q147 Chair:** But jointly commissioning is of itself a concern, frankly, if I can say so. If you want a regulator that is a tough regulator, that is holding you to account, the joint commissioning again seems a very cosy relationship.
***David Higgins:*** But the report then goes to the ORR. The other way round, we duplicate it, we set our entire own set of other internal experts, the regulator arrives with their Arups and Halcrows; we then fight that, we get our lawyers and everyone else and prove that they are technically incorrect, we argue for a year and a half and we never do anything. All I want is a report that says where improvement can be made and where we can take actions. I am not about fighting reports, and all the reports that have come through that I have seen today are fairly tough and come up with ideas.
I think the challenge we all grapple with here is the scale of this regulation. This is the same as all the water and sewerage companies in the entire UK. It is four times Heathrow: that is what it is. It is just fractionally under those water companies. Our regulator has to base at £40 billion; for all the water companies across the UK, in Northern Ireland and Wales, it is £50 billion pounds. Heathrow is £9 billion, so this is four Heathrows, or nearly all the UK water companies as a business, and—scarier than that—it is totally mission critical.

**Q148 Chair:** The costs of the regulator—one of the things the Audit Office says—is quite small, and its expenditure on value for money, and losses—I cannot remember, how many million? What is it Mr Emery? Just give me a quick figure.
***Bill Emery:*** £28 million is our budget.

**Q149 Chair:** Maybe the NAO can work it out, but there is a figure you have somewhere: £13 million, £14 million?
***Bill Emery:*** £14 million; that is on—

**Q150 Chair:** £14 million, okay; so do you think that is too little, is that what you are telling us? David, is that too little?
***David Higgins:*** What, for the regulator? I could not comment on that
**Chair:** Let me ask you another question.
***David Higgins:*** I know what you would say if I did.

**Q151 Chair:** On Thameslink and Crossrail, as I understand it from page 22, para 3.7, you signed some sort of direct deal, so the regulator never got involved. What difference did that make?
***David Higgins:*** That is directly with the Department for Transport; there we are essentially a contractor to deliver those projects with the Department for Transport.

**Q152 Chair:** So who looked after either efficiency or consumer interest, which is what the regulator is supposed to do?
***David Higgins:*** The Department for Transport set the brief. In the case of Crossrail this is a company, which is a joint company by Transport for London, of course, and DfT. They set the brief as to how many trains per hour—

**Q153 Chair:** So why can’t we do that for everything? If you have a perfectly okay relationship on these two rather important rail infrastructure projects, Thameslink and Crossrail, where the regulator has no role—
***David Higgins:*** Well, the regulator is aware of what we are doing, but the budgets—in fact, does the regulator not have oversight—
***Chair*:** I think the regulator—page 22, let me have a look at it, because I obviously picked it up when I was reading it.
***Bill Emery:*** Certainly in terms of these major projects the Government has taken the major client role and has an arrangement. We did not go into testing the efficiency of those particular ones because it was being dealt with by DfT, and it is a choice.

**Q154 Stephen Barclay:** The Report suggests that there needs to be change, because, looking at page 9 paragraph (e), it says, “The regulator should have the opportunity to engage with their development”—this is in terms of direct agreements—and it is very unclear in terms of whether you will have that, because it says, “May continue to feature in the rail investment programme.” I suspect that what the Chair, and we as a Committee are looking for, is some certainty on this: will you have an involvement in these sorts of agreements moving forward?
***Bill Emery:*** We believe that we should have a greater involvement, we believe it would have been a better solution if we had been, and that is our line that we have taken with the DfT. At the end of the day it is a matter for DfT and Transport Scotland on these matters. They have seen quite a lot of value, particularly on some of the issues around Thameslink and the issues around Glasgow-Edinburgh improvement for the involvement of the regulator after the fact. We would have been better involved right at the front, and this being done in a more conventional regulatory model, rather than it being a special project.

**Q155 Stephen Barclay:** So you made these representations to the Department. Have the Department given a view or indication of when they will give a view?

***Bill Emery:*** They will be part and parcel of responding to some of these questions, and I think that they are minded to look at it again.
***Amyas Morse:*** Would you say, Mr Emery, if you had been involved in the Crossrail project that it might have gone less massively over budget than it did?
***Bill Emery:*** I think Crossrail is difficult; it is an early stage in Crossrail, isn't it?
***Amyas Morse:*** So is the stage of surface trains that you can be involved in?
***Bill Emery:*** The issue for the regulator is where we get involved; it is certainly dealing with the mainline railway. Thameslink is on the mainline railway. That is really because all the interfaces are there. Crossrail and central tunnels, that is completely separate, and that can be dealt with outside. When it gets to all the work that Network Rail has to do at both ends, then that is best done, in our terms, with regulator oversight through the mechanisms that we have. Clearly there are lessons to be learned from these and the involvement of the regulator, and the Government is looking quite carefully at it.
***David Higgins:*** Just on that point there, is the ultimate check, on the both those projects, not that the above ground rail has to go into the regulated asset base, and nothing can go into the regulated asset base unless the regulator signs off on it.

**Q156 Chair:** I have two very quick questions, and they have to be quick because everybody has a 17:30 meeting. One really to the regulator: across Government there has been a real attempt to drive for better regulation. I remember the Better Regulation Task Force, there is a Better Regulation Commission, there is a Better Regulation Executive; indeed, for a little bit of a time there was a Department for Business, Enterprise and Regulation. What has got better?
***Bill Emery:*** There is substantially more transparency in the information, and the core principles of better regulation have become established in the way in which regulators work. I think there are issues around getting the right balance between who is setting the overall policy and who is doing the oversight of the companies.

**Q157 Chair:** So transparency is better?
***Bill Emery:*** Transparency is better. In rail I think, because Parliament has imposed the high level output specification and public-statement-of-funds-available model, where the Government is making very clear what it wants from the railway, which does not exist so much in other sectors.

**Q158 Chair:** Okay, I will just make the observation, I have to move us on. It is a shame that in getting transparency we have not got good unit costs, because that, for me, would have been important. The very final thing is to you that there has been quite a lot in the press about safety with Elsenham—I am sure you know about the articles in *The Times* around the two young girls that were killed on the Elsenham level—and there is a suggestion in the press that two reports on the safety of that level crossing were deliberately kept back, or were deliberately hidden from Government investigators, deliberately withheld from Government investigators. Is that true?
***David Higgins:*** Firstly, this is subject to an ORR review; it has been reopened, so it is probably not wise to talk on that until that finding comes out. What that press article today in *The Times* spoke about was a Railtrack memo that emerged in 2006, but was written in 2001. When I saw it in the files I sent it to the regulator and in fact to the family members, and it was two or three months ago.

**Q159 Chair:** So any relevant information that would help in the investigation—
***David Higgins:*** It was a memo in 2001 from the Railtrack organisation, and I think it is described in *The Times* correctly. The story on level crossings is, while we do have, compared to Europe, a good record on level crossings—we run the safest train level crossings in Europe—our standards here need to improve, and significant improvements can be made, and we will launch, on 9 June, an initiative to strengthen them. Elsenham was all about risk assessment; it was how the risk at a crossing is assessed, who did it, what their competencies were, what happened to the information afterwards and what decisions were made.

**Q160 Chair:** Okay, I understand all that. What I understand is that there are two documents, but the memo of 2001 was sent in 2006?
***David Higgins:*** Sorry?
**Chair:** When did all the relevant people get it?
***David Higgins:*** Two months ago, I suppose.

**Q161 Chair:** Only two months ago?
***David Higgins:*** But if it was deliberately withheld and it was material, that is something that the ORR would determine.

**Q162 Chair:** And when are you reporting on that?
***Bill Emery:*** We are in the middle of our investigation, and we hope to report in a few weeks' time, when we have gone through it all and reopened it as to whether or not this changes the decision taken originally on the culpability of Network Rail for this particular event—

**Q163 Chair:** And do you wish to add any comments on whether it was deliberately—
***Bill Emery:*** I do not want to comment at this stage.
**Chair:** Okay. Alright, thank you very much indeed. Thank you.

## Tuesday 7 June 2011

Members present:

Rt Hon Margaret Hodge (Chair)

Mr Richard Bacon
Stephen Barclay
Stella Creasy
Jackie Doyle-Price
Matthew Hancock
Chris Heaton-Harris
Joseph Johnson
Austin Mitchell

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**Amyas Morse**, Comptroller and Auditor General, **Alex Scharaschkin,** Director, and **Marius Gallaher, H M Treasury**, Alternate Treasury Officer of Accounts, gave evidence. **Geraldine Barker**, Director, NAO, was in attendance.

**REPORT BY THE COMPTROLLER AND AUDITOR GENERAL**
**Regulating Network Rail's efficiency (HC 828)**

**Examination of Witness**

*Witness:* **Lin Homer**, Permanent Secretary, Department for Transport, gave evidence.

**Q164 Chair:** Welcome, Lin.
***Lin Homer:*** Thank you.
**Chair:** We deliberately gave you a bit of time to get your head around these issues because we recognise that you have just arrived in the Department. Since we had our last hearing the McNulty review has confirmed what we all already accepted: that UK rail costs are unacceptably high. The unit cost is somewhere in the region of 40% higher than the average in Europe, so we are talking about billions of pounds at stake here. We really want to know: how are you going to get a grip on these costs?
***Lin Homer:*** Thank you Chairman, and thank you for separating out my appearances in front of you, it is very much appreciated. I think you are right; it has the advantage of allowing us to meet again with some further activity underway. What the Secretary of State has already made plain is that we welcome the McNulty review; we think it has been a collaborative approach to gathering both views about what has worked well and what remains to be done in the railways, and we intend to look very carefully at all the recommendations from the review.
The Secretary of State has already made plain that he is prepared to accept the recommendation that he should undertake a fares review. We would now propose to go forward on the agenda that has been set out there and utilise the period between now and the [1]autumn to undertake some further work to try and build on both that review and indeed the work that you have done in a number of your recent reports, and come up with a strategy for rail for the next period that builds on what we learnt from these reviews and from recent experience.

**Q165 Chair:** So how are you going to get a grip on the costs?
***Lin Homer:*** In the review McNulty makes it very plain that rail has achieved quite a lot in the last period but that value for money has not been an explicit part of the agenda of the industry in a way that would drive it through as a key issue everywhere. What he is suggesting within the review is that there is a need to make specific requirements for value for money to be an issue and for the regulator to hold Network Rail to account. The industry needs to focus on and we need to drive through value for money both in our broader role in relation to franchising and in our interaction with rail on a more general basis.

**Q166 Chair:** I am trying to lead us to how you would get a grip on costs. Will you put tougher requirements on the regulator to achieve that?
***Lin Homer:*** We believe that there are a range of things. Roy McNulty says in terms in his review that it would be wrong to suggest that the next stage of rail reform is a single silver bullet.

**Q167 Chair:** I have looked at a bit of the McNulty review. First of all it is 40%, we have all known it is 40%, it is confirmed again with McNulty. It is a huge document but I looked at the summary and one of the most depressing graphs, which you will not have there but you can probably see it from here, is the relative efficiency graph. This shows that since privatisation, relative efficiency has become worse and worse.
***Lin Homer:*** Let me mention some of the specifics—

**Q168 Chair:** Now I accept you are still relatively new in post, but we need some real specifics on what you are going to do to get a handle on this, rather than just saying that you are going to review the review.
***Lin Homer:*** Let me say first of all that the Government is going to look at this from a policy perspective over the next six months and it would be wrong of me to anticipate that review.

**Q169 Chair:** So you are reviewing the review?
***Lin Homer:*** No, we are reviewing the broader response to the challenges that McNulty puts on the table. Let me mention some: as you say, both the foreword and the summary of Roy McNulty's report are helpful. He talks about the fragmentation of structures and we are looking at work that will ensure that Network Rail and the train operating companies can look differently at the way the rail is run and that

[1] A copy of Anthony White QC Report on financial impropriety and misusue of public funds by Network Rail has been placed in the House of Commons Library

we can see whether there are ways of aligning the incentives.

**Q170 Chair:** Can I just stop you there? We will come to structure but I sigh in desperation that the answer to an absolute imperative, to ensure better value for money, is simply to restructure the rail industry yet again.
***Lin Homer:*** No, you asked for some examples and I was simply giving you them in the order they appear in the report. That was not the only or the simple one. I was moving on to alignment of incentives, because I think that is something that you as a Committee have talked to us about. What the report highlights, and what our experience and your reports confirm, is that at the moment the incentives do not align within the industry—Roy uses the phrase that people can "game" the system—so we are particularly interested in looking at the alignment of incentives, the ways you can ensure the infrastructure provider, the operators, can share risk and benefit from driving efficiency out of the system rather than just moving fault around the system, which certainly is one of the risks of the current system. I think the alignment of incentives, which is something we have talked about with you on previous occasions, is another major part of this.

**Q171 Chair:** When and where are we going to see that alignment being implemented in practice?
***Lin Homer:*** There is already discussion about moving to some very early opportunities around that.

**Q172 Chair:** Where?
***Lin Homer:*** Within the review, McNulty is suggesting that we could look at some early pilots about the opportunity to trial some geographical arrangements. He mentions one route, but it is clear that it could be a number of routes where you could look at allowing either a different arrangement for concessions or a different arrangement for maintenance. You can actually try and practice to align those incentives.

**Q173 Chair:** So in your next letting of your next franchise, I cannot remember which one it was—
***Lin Homer:*** We have a number coming up.

**Q174 Chair:** Okay, so will we be able to see there a better alignment of incentives between Network Rail and the operator?
***Lin Homer:*** We think that is a great opportunity and—

**Q175 Chair:** Will we be able to see it there?
***Lin Homer:*** Yes, and another opportunity, which again the Secretary of State has indicated that he is prepared to take, is to allow longer franchises so that there can be more opportunity for those commercial opportunities to be driven out during the period of the franchise.

**Q176 Chair:** And what else?
***Lin Homer:*** There is also a clear reference in the report to what Sir Roy calls a "culture which is not conducive to the partnership and continuous improvement". We believe that we need to look with the regulator at how we drive a change in culture, so that as well as looking at both safety and capacity we can also ensure there is a pressure on producing measurable contiuous improvement.

**Q177 Chair:** What does that mean in practice?
***Lin Homer:*** What it means in practice is—again something that you have taken up with us—that we need to look for ways of collecting better, more granular data so that we can see not just the performance of the system overall, but the relative performance between parts of it. We can use that to drive what some people are calling internal contestability as well as the European benchmark—

**Q178 Chair:** Your Department has been saying it needs better data for 10 years. When are we suddenly going to miraculously see this better data?
***Lin Homer:*** We have better data than we did. I do not think we have stood still in the last 10 years. When David Higgins and Bill Emery were before you, David Higgins himself accepted that there is a need for more of their data to be not only absolutely assured in quality but also more granular. So you can look at routes, you can draw down into different performances in different parts of this system, and you can then use that to drive out challenge and improvement as you go forward. I think some of that should start to appear very quickly.

**Q179 Chair:** At the moment the only way in which Network Rail can be held to account is by fining them. Is that a sensible way of incentivising cost reduction?
***Lin Homer:*** The regulator would argue that there is a wider range of approaches.

**Q180 Chair:** When he was here he said that was his only power—am I remembering this wrong, can somebody help me?—was the power to fine. I am asking you what you think, rather than what the regulator thinks.
***Lin Homer:*** I think there is a need for us to look at the structuring of the industry. The Report from the NAO made it clear, and this is something that you took up with the team, that in an area where the provider of the infrastructure is neither accountable to shareholders nor as information-rich as we would like, regulation can fail to have traction. I think the Secretary of State is interested in looking at whether there are ways in which we can create a governance structure that does allow us to strengthen the accountability.

**Q181 Chair:** So again your answer is to restructure as a way of trying to incentivise cost reduction?
***Lin Homer:*** No, but I think governance can allow incentives to work as well as fines.

**Q182 Chair:** What does that mean?
***Lin Homer:*** Well, we do have benchmarking and much of what has happened in the McNulty review and much of what happened in the NAO review was a powerful illustration that if you hold up examples of other practice within a business or within similar businesses, it can become a driver to a different level

of performance. The regulator does have the right to ask for explanations about activity and they have done that in the past. Again that does have some power. They can ask for recovery plans and of course they can, in ratcheted-up approaches, use fines. What we would want to do is take your lead to have discussions over this next period about how all of those work, how you can create a spectrum of interactions and how you can drive greater accountability and greater performance improvement.

**Q183 Stephen Barclay:** I am slightly baffled about the spectrum of interaction and things like that. I think that is exactly what we have already got, and it is not working. You talk about changes to governance but in one of the notes you gave to the Committee you specifically ruled out one of the key changes to governance, which was giving the National Audit Office access to Network Rail. You said that was because they are a private company. Can you explain that decision?
***Lin Homer:*** Yes. This is something I have discussed with the Treasury. I think a clear line has been drawn around the NAO's role. As this hearing, the Report itself and your previous interactions illustrate, you have significant access to the workings of the Department and the regulator. To move beyond that and to have the NAO as auditor of a private company seems, to the Government, to be an inappropriate way to go. I think we can accept the advice given in the front of your last Report that we should ensure there are mechanisms that hold organisations to account when they are neither public nor have the direct influence of shareholders. Government accepts that that is something it should take a lead in looking at.

**Q184 Mr Bacon:** What is a private company?
***Lin Homer:*** In this case, it is easier to discuss what makes this not a public company.

**Q185 Mr Bacon:** What I would really like you to do is to answer my question. You used the phrase "private company". I am just asking you to define the term that you used. What is a private company?
***Lin Homer:*** It is not owned by the public. We contribute to the costs of Network Rail and it is a relatively—

**Q186 Mr Bacon:** When you say "we" you mean taxpayers?
***Lin Homer:*** Yes, through Government.

**Q187 Mr Bacon:** I know that private companies bid for Government contracts but it is not normal to be spending money in the way that you are doing here on private companies, is it? In that respect, it is not a normal private company, is it?
***Lin Homer:*** It is quite a unique arrangement and I think that is why it is worth us looking at it.

**Q188 Stephen Barclay:** When the Chief Executive of what you described as a private company said in his evidence to the Committee, "It is neither a private company nor a publicly owned one," was he wrong in talking about his own company?
***Lin Homer:*** I think he was struggling for a definition that captures this—

**Q189 Mr Bacon:** I am interested in your definition because you have called it a private company. Can I buy or sell the equity of this private company?
***Lin Homer:*** No, but nor can I—

**Q190 Mr Bacon:** No, okay. Now, can I buy or sell the equity of private companies normally?
***Lin Homer:*** Not all, some are funded by—

**Q191 Mr Bacon:** I am sorry, quoted ones of course. There are private companies that are privately held where the shares can be bought and sold only at the say so of the owners and there are others that are quoted on the public stock exchanges and anybody can buy or sell them and they are much more liquid, I accept that distinction. You are saying I cannot buy the equity of this particular company in that way, whereas for many other quoted private businesses I would be able to. That is correct is it not?
***Lin Homer:*** Yes, but you did not ask me what would make this a quoted company.
**Mr Bacon:** I understand that.
***Lin Homer:*** The NAO's role has been quite distinctly agreed with Government, including the Treasury, and this would take it another stage on.

**Q192 Mr Bacon:** What I am really puzzled by is why you insist on calling it a private company. It does not have equity that we can buy or sell; it has public money that you put into it. It does not appear to have any of the normal characteristics of a private company.
**Joseph Johnson:** It does not have private risk capital in it.
***Lin Homer:*** No, but that is not the definition of a private company.

**Q193 Mr Bacon:** What I am trying to get to is why you are calling it a private company when it plainly is not?
***Lin Homer:*** I am quite content to accept that what it is not is a public company and that is where NAO's expertise has been focused.

**Q194 Matthew Hancock:** If it were a private company wouldn't giving subsidies to it be against European state aid rules?
***Lin Homer:*** We are paying for services that are provided. The distinction here is that we are not subsidising and this is not a company—

**Q195 Mr Bacon:** It does not have to compete in the way that a private company would in order to bid for the right to provide you with those services, or have a notice of period in the Official Journal and have everybody compete for the chance to provide those services. You just pay this particular entity money for services don't you? That is how it works.
***Lin Homer:*** And when David Higgins was in front of you—

**Q196 Mr Bacon:** Sorry, instead of saying "and", could you just say—
***Lin Homer:*** If you want me to answer the question I will. When David was here, one of the points that he made was that he believes there should be more contestability and there is a great deal of provision of the work that the Government pays for through other companies, so it would be wrong to suggest that we just hand over money to Network Rail and there is no contestability, but there is a uniqueness about this company. I am agreeing with you about that.
**Mr Bacon:** Yes, sure.
***Lin Homer:*** We are disagreeing with you about whether that per se means the NAO—

**Q197 Mr Bacon:** The point is that what you said right at the beginning frankly astonished me in one sense. You said that value for money has not been part of the agenda and you were quite candid about that. Surely the whole point is that one of the reasons value for money has not been part of the agenda is there has not been sufficient scrutiny of Network Rail. If there had been greater scrutiny of Network Rail and the National Audit Office was the appointed auditor, in the way that it is for many other publicly funded bodies, then the National Audit Office would have been able to do more in the way of value-for-money studies on the work of Network Rail and identify many of the deficiencies earlier. This has not happened. This independent scrutiny, which would have led to a greater drive for value for money, which you admitted right at the beginning is absent, would have happened, and it has not. One of the obvious ways to get it to happen is to have greater access for the National Audit Office. I cannot understand why you are digging in your heels and saying that is not the route and it would be too far to go. What is your answer? Because it is a private company—that is what you said. We have established that, no, it is not a private company.
***Lin Homer:*** I disagree. I do not think we have established that it is a public company.

**Q198 Mr Bacon:** We have established that it is not a private company.
***Lin Homer:*** I do not believe the NAO has a precedent for carrying out a role in these kind of hybrid companies.

**Q199 Mr Bacon:** What about foundation hospitals? They are independent.
**Chair:** Foundation trusts and academy schools?
***Lin Homer:*** They are on the public books as—

**Q200 Joseph Johnson:** To all intents and purposes it is a public company. If it walks like a duck and talks like a duck, it probably is a duck. What you are displaying seems to be a reluctance to have the NAO audit it for reasons which are not entirely comprehensible to me.
***Lin Homer:*** Yes, we are reluctant.

**Q201 Joseph Johnson:** Why?
***Lin Homer:*** Because we do not think it is an appropriate use.

**Q202 Chair:** Why?

**Q203 Matthew Hancock:** Hold on. Are you in favour of better value for money within Network Rail? Yes or no?
***Lin Homer:*** Yes, and in rail generally.

**Q204 Matthew Hancock:** Right. Do the NAO, where they audit public bodies, tend to make suggestions that would help improve value for money?
***Lin Homer:*** Yes and the focus is on that improvement in areas where the public is directly providing those services.

**Q205 Matthew Hancock:** You are saying that we should not have NAO coverage over Network Rail because it would be a waste of NAO resources; isn't the Comptroller and Auditor General the best judge of that?
***Lin Homer:*** I think Government has a say in that as well.
**Mr Bacon:** No, actually it does not.
**Matthew Hancock:** That is the whole point.

**Q206 Mr Bacon:** The Public Accounts Commission has a say. You are absolutely wrong. It is no business of Government how the NAO spends its money—none. The Public Accounts Commission in the National Audit Act 1983 funds the National Audit Office. The National Audit Office is funded by Parliament. The Comptroller and Auditor General is answerable to the Public Accounts Commission for how it spends its money. It is no business of yours. The Treasury has an input and is invited to give its comment, but it is no business of yours whether the NAO is, in your words, wasting its resources or not, none.
***Lin Homer:*** I want to correct you. I did not suggest the NAO was wasting its resources, those were not words I used. I also did not say I disagreed. It is an issue I have discussed with the Treasury and it is the shared view with the Treasury.

**Q207 Chair:** Right, I just want to draw this to a close with two questions. First, I want to ask our Treasury colleague why the Treasury have taken that view.
***Marius Gallaher:*** The Office of National Statistics classifies this company to the private sector. Most of its funding comes from the private sector and in the—

**Q208 Chair:** That is not true.
***Marius Gallaher:*** Network Rail is financed mainly through debt raised from the capital markets.

**Q209 Chair:** Hang on a minute, before you make that statement it is not true that most of the money that goes into Network Rail comes from the private sector, is it?
***Alex Scharaschkin:*** About two thirds of its income last year was from the grant in lieu of track access charges.
**Chair:** Thank you.
***Marius Gallaher:*** Yes, but the debt over the years has come from capital markets. As such, the Office of

National Statistics has classified it not to the public sector.

**Q210 Stephen Barclay:** The debt is fully underwritten by Government, is it not?
**Joseph Johnson:** It is quasi-sovereign debt?
**Mr Bacon:** Can you just say that answer clearly: is the answer to Mr Barclay's question yes? I thought you said yes, I just want to be clear on the record.
***Marius Gallaher:*** At the end of the day the taxpayer may have a liability, but—

**Q211 Chair:** May?
**Mr Bacon:** Are you saying it may not?
**Matthew Hancock:** The ONS has done a very clear report into the status of Network Rail's debts and whether they should be counted as public sector debts. What was the result of that report?
***Marius Gallaher:*** It was not classified as public sector debt as far as I am aware.

**Q212 Joseph Johnson:** So it is off balance sheet but the taxpayer is on the hook for it. It trades as quasi-sovereign debt in the capital markets. If you are saying very clearly that the taxpayer is not going to stand behind Network Rail's debts, the capital markets are going to want to know about that.
**Mr Bacon:** They probably already do.
***Marius Gallaher:*** If the Office of National Statistics classifies it to the public sector, that changes the whole situation completely and the Treasury would be quite happy to look at the status of the company in that situation.

**Q213 Chair:** Are you saying on behalf of the Treasury that Government is not standing behind that debt?
***Marius Gallaher:*** I cannot say what the Government will do in the future; it would be difficult for me to do that now.

**Q214 Joseph Johnson:** So you do not presently stand behind it?
***Marius Gallaher:*** We do not give guarantees.

**Q215 Chair:** That is extraordinary and I think perhaps we need a note, probably from you, Lin Homer, as to whether or not the Government would stand behind the debt, so that we can get our definitions clear.
Can I ask you another question? Let's set aside the issue of who does the audit of Network Rail, because foundation trusts can be audited privately and academy schools can be audited privately. The point really is that the NAO has access to all the information in foundation trusts or in academy schools and free schools; it does not have access to information within Network Rail. It is our view that that access should be allowed because that would enable us to support the work that we hope the Government will do to eke out better value after this disastrous performance. Do you not agree with that?
***Lin Homer:*** In answer to your earlier question, I said that I thought the work you have done through the NAO—

**Q216 Chair:** Why can't the NAO have full access to Network Rail information? I am not asking about the audit, let us leave that aside; why can't they have access to the information?
***Lin Homer:*** I think it is part and parcel of the same debate. The question is: for what purpose and for what function? The Report you wrote on *Regulating Network Rail's efficiency* made some very particular comments about the quality of data and the transparency of it. This Government stands behind transparent data and if between ourselves and the NAO we were able to identify more granular information that should be made available, that would be something we would be very supportive of.

**Q217 Chair:** We will clearly have a conclusion on this from our Report, which would enable us to have full access to information in Network Rail, even if we do not audit. Would it be your view, and I hope the Treasury's, that that is acceptable?
***Lin Homer:*** We might have a discussion about "full". It goes back to the status of the company.
**Chair:** I think that is a very important discussion.

**Q218 Stephen Barclay:** I just want to move on to compromise agreements. My understanding is that Reports of the NAO are agreed by your Department before they come to Committee. Are they?
***Lin Homer:*** Yes

**Q219 Stephen Barclay:** Okay, so if I can just refer to the Report of 1 April 2011 from the Office of Rail Regulation. In the second paragraph of the summary, on the very first page, it says, "It is a not-for-dividend private sector company limited by guarantee, financed not by equity but by debt, guaranteed by the Government". So this Report is saying that the debt is guaranteed by the Government. I assume this Report was agreed by your officials?
***Lin Homer:*** This Report was signed off by ORR and I did specifically check the basis on which it was given to me. It was not given to me for me to validate every sentence but, as my colleague has made plain, we do accept that de facto that guarantee has been in existence.

**Q220 Joseph Johnson:** This is directly contradicting what the Alternate Treasury Officer of Accounts just said.
***Lin Homer:*** We talked quite a lot about whether or not it was a private company and that is also in the Report. We were having a healthy debate on it a few minutes ago.

**Q221 Joseph Johnson:** We have just been given completely contradictory information by the Alternate Treasury Officer of Accounts. He very clearly said that they do not issue guarantees. Your Department has signed off on a Report that says that the debts are guaranteed by the Government.
***Lin Homer:*** I did not sign this Report off as Accounting Officer; I need to be clear about that. I did check that with NAO at the time because I saw it in draft and I was assured that it was not formally

signed off by me as Accounting Officer in the way that the Reports on us are.

**Q222 Joseph Johnson:** What is the situation: are the debts guaranteed by the Treasury or not?
**Matthew Hancock:** Well, they are because according to your—
***Lin Homer:*** I think that is the de facto description, not a legal description.

**Q223 Matthew Hancock:** I will just read out from the Network Rail website, "This Programme benefits from direct and explicit support from the UK Government in the form of a Financial Indemnity from the Secretary of State for Transport, a Minister of the UK Government". That might help.
***Lin Homer:*** De facto we are the major funder of Network Rail; I do not think there is any disagreement about that.

**Q224 Joseph Johnson:** Why don't we roll back to the previous reasons given by the Treasury for not describing this as a private company? One of the most important among them was that its debts were coming from the private sector. However, we have seen that the capital that is coming from the private sector is guaranteed by the Government. Therefore, effectively it is coming from the public sector.
***Marius Gallaher:*** What I was trying to go on to say was that per se the Treasury does not normally hand out guarantees straightforwardly or willingly like that. We have to be cautious about giving such guarantees. However, if that is the position in the Report and it is confirmed by the Department we are happy to stand by those guarantees.

**Q225 Chair:** Does that therefore change your attitude to the full accountability of Network Rail to Parliament?
***Lin Homer:*** No.

**Q226 Mr Bacon:** You would rather have this dodgy system with this funny list of people. I was looking them up—I do not know if this list is accurate but it is from Network Rail. Do you know who all these Network Rail members are? Have you come across them or met them?
***Lin Homer:*** I have not personally. I thought I said very clearly, but I will happily say again, that the Secretary of State does have a view, guided by you, that we should take the lead in looking at the governance arrangements for Network Rail.

**Q227 Stephen Barclay:** Who determines what is commercially confidential: is it Network Rail or is it the regulator?
***Lin Homer:*** The regulator can call for certain information but there will be information Network Rail—

**Q228 Stephen Barclay:** No, that was not my question. My question was about the fact that the commercially confidential information is not disclosed to the Department or to the Secretary of State. What I am trying to understand is how widely that is defined. Is it defined by Network Rail or is it defined by the regulator?
***Lin Homer:*** My understanding is that it is defined in agreement with the regulator, so that will be subject to their periodic reviews. They will call for information in an arrangement that is agreed, but we do have to take account of the fact that there clearly is commercial information that has to be respected as such.

**Q229 Stephen Barclay:** Is there not therefore an information asymmetry if the regulator has a duty to disclose to the Secretary of State if he is going to make a fine and to take on board the Secretary of State's comments on the impact that may have in terms of going outside of his budget, whether it is likely to have a materially negative or positive financial consequence for the Secretary of State, but there is no disclosure in terms of commercial confidentiality issues within the company and, indeed, it may be that Network Rail themselves who are defining what is commercially confidential.
***Lin Homer:*** I am not sure what the question you are asking is in terms of definitions. The regulator has a right to call for certain information.

**Q230 Stephen Barclay:** The question I am asking is about you as an Accounting Officer having a duty to satisfy Parliament that you are obtaining value for money. It is difficult to do that if, on the one hand, you are getting information on the fines, but you are not getting information on what is commercially confidential and you are not able to satisfy yourselves as to how robust the regulator is in terms of what is being defined as commercially confidential. Let us bring it to life with an example. In a note from our last hearing we discovered that since 2006 Network Rail has entered into 300 compromise agreements. Now, in his evidence the regulator said that he did not scrutinise compromise agreements, so who is scrutinising Network Rail's compromise agreements?
***Lin Homer:*** You are right; those have been scrutinised by the company and I think it is—

**Q231 Stephen Barclay:** By who? By all these 100 or so members? Did they get a copy of them?
***Lin Homer:*** That would be for the company to decide. They will have committee and board arrangements in line with the practice of not-for-profit private sector companies and they will be accountable.

**Q232 Stephen Barclay:** How, as Accounting Officer, are you satisfying Parliament that the money you are allocating and the debts you are underwriting are value for money when there are 300 compromise agreements out there that no one seems to be looking at?
***Lin Homer:*** One of the ways that I am suggesting to you we are going to do that is to utilise your views and the McNulty review views to look again at this issue. What I am simply not agreeing with you about today is that the outcome from that look will definitively, simply and only be the role for NAO that I know is your recommendation. I am accepting, and I will say it again, that we do believe that the work

you and Roy McNulty have done, and the experience of the last period, suggest that it is time for us to look again at the Government's arrangements.

**Q233 Stephen Barclay:** What is the total value of the 300 compromise agreements entered into by Network Rail?
***Lin Homer:*** I do not have that information.

**Q234 Stephen Barclay:** Can you get that in a note for us?
***Lin Homer:*** I have access to the report that I believe you have access to, which outlines some of the issues that have been undertaken in relation to HR in the last period, so in fact you and we have a similarity of information in that, but I am happy to confirm that in a note.

**Q235 Austin Mitchell:** I have come to the conclusion that it is not particularly a private organisation, it is not particularly sui generis, it is not particularly anything. I would like to revert to the question the Chair asked earlier about sanctions on Network Rail if it does not perform properly. What is wrong with giving the regulator the power to regulate their salaries and bonuses?
***Lin Homer:*** The Secretary of State is on record saying that he was disappointed with the bonus decisions that were made last year and he thinks it is an area where the regulator should set clearer parameters and should link some of the objectives to the management incentive plan.

**Q236 Chair:** What does that mean? That the Department and the Secretary of State believe that in the future the regulator will determine the salaries and bonuses of top officials in Network Rail?
***Lin Homer:*** There is a difference between "determine" and "set parameters".
**Chair:** What does that mean? Set parameters—a top and bottom limit?

**Q237 Austin Mitchell:** Is it a devout wish in a would-be world or is it a serious purpose of Government?
***Lin Homer:*** It is a serious purpose of Government that the regulator will set objectives that will form hurdles to the management incentive plan—I think that is the phrase that has been used. Now that is not the same as the regulator becoming the remuneration committee of the board but it is a clear wish on our part and on the regulator's.

**Q238 Chair:** In his evidence to us the regulator said he was disappointed by the bonuses given to top officials, in particular Iain Coucher during his time as Chief Executive of Network Rail. He was disappointed, full stop. Nothing happened. What is going to change in the future to ensure that the payment of salaries and bonuses for top executives in Network Rail are more closely aligned to performance?
***Lin Homer:*** In the next control period, high-level objectives are clear that we expect the board and its remuneration committee to take account of the annual assessment in decisions relating to the management incentive plan, so in effect there is a link between performance and bonuses.

**Q239 Joseph Johnson:** And if they do not?
***Lin Homer:*** Then we are back to the question of incentives, fines and sanctions. There is then a question about whether there are ways in which those financial penalties can be made to bite more clearly. That is of course an area that you would need to—

**Q240 Austin Mitchell:** I hope he has more than the power to wring his hands. I have just one question on costs. Christian Wolmar suggested, when the McNulty report came out, that it ignored a major aspect of costs: the huge legal, accountancy and professional consultancy costs of negotiating all of these contracts, whether they be compromise agreements by Network Rail or the contracts with companies. Those costs must be huge and there are big differences between what happens here and what happens in sane railway systems. Is it possible to get any idea of what the costs of all these legal service lawyers, who are a bit better paid than horny-handed sons of rail, and accountancy and consultancy services are to both sides of the argument?
***Lin Homer:*** If we did end up with more granular data, which is something you suggested and something we support, there would be more opportunity to have transparent discussions about where the expenditure was going. Again, when David Higgins was here he said in terms that he believed they could be more effective and that he thought it was right to share more granular information.

**Q241 Austin Mitchell:** Can we have positive published information? All these negotiations are a long, protracted haggle, largely legal, in which there are highly paid legal teams on both sides. Your side has consultants and its own lawyers and the company is employing highly paid lawyers themselves. There must be an enormous cost involved in all of this.
***Lin Homer:*** I agreed earlier that we are all saying there should be more published information.

**Q242 Austin Mitchell:** Well, there should, but can it be published?
***Lin Homer:*** There should be more published information, yes. What I said earlier is that I am not suggesting that I believe absolutely every piece of information Network Rail has should be published. So the question about—

**Q243 Chair:** Who is going to decide what is published?
***Lin Homer:*** I think it is a matter for the regulator.

**Q244 Chair:** Not for you?
***Lin Homer:*** We also had a very clear recommendation from McNulty that the role of the regulator and the role of the Department should be more clearly distinguished.

**Q245 Chair:** The role of who does what? This is just a question of information. What we are after is much greater transparency so I want to hear from you: who is going to decide? You have said you do not want the NAO to be able to access all the information. Who is going to decide what is going to be accessed and what is going to be published?

***Lin Homer:*** The regulator has the main role in that, but the Government has an opportunity to set the strategic direction and, in entering into its five year funding arrangement with rail, to make requirements on what it expects to get in relation for that and what information should be available.

***Amyas Morse:*** Can I just ask something about the cost structure, Chair? What the McNulty report has confirmed is the same as what the regulator is saying, largely speaking, which is a big structural differential between the costs of rail provision in the UK and in the continent. If you are comfortable that that is right I would hope there might be a response on two levels: first, at an incremental level—putting better drivers in place and all the other good things that gradually will drive down costs. Also, surely with such a large gap there is a case for having a programme of structural cost change over a much shorter period to get us into roughly the right place. Do you think that is fair?

My worry is that we are talking about lots of mechanisms that will gradually drive at the costs, but given the scale of the gap and the fact that it is acknowledged to have been there for quite a long time—it is not very different in the McNulty report from what was known before—the question is: how is that gap to be bridged? I am not asking it as a difficult question, but would you say the ambition is to get it down in a stated fairly few number of years to something manageable?

***Lin Homer:*** Yes. The Secretary of State, in welcoming the report, believes that the aspiration set out in the report to drive up the existing plans for CP4 beyond their current level to an estimated 30% reduction in costs by 2018 is a reasonable aspiration for us to bid for. That may not be quite as short a period as some would believe, but again there is a general agreement that you need something pacey but realistic. We would put our weight behind that broad plan.

I know you will not want to hear this but I would just add that, in looking at Europe, there are differences in the way rail companies are regulated as well as in the way they perform. Actually ours is already a more heavily regulated business than in most of Europe, so that is one of the reasons we want to take the opportunity to think about the next phase, rather than to just assume, as Roy McNulty said, that there is a single silver bullet. That is the reason for a degree of caution about single responses to this but we absolutely put ourselves behind that main aspiration.

**Q246 Chair:** Okay. I am going to move us briefly onto some of the McNulty issues around structure and then we are going to focus finally on the regulator.

McNulty is suggesting yet another reorganisation and I personally dread that because all the focus will be on reorganising the industry, rather than trying to eke out efficiency. You have said in principle that you accept all the McNulty recommendations. How are you going to ensure that you are not going to drive additional costs into the system?

***Lin Homer:*** We welcome the report; I do not think that is the same as—

**Q247 Chair:** You have said that before; focus on the question.

***Lin Homer:*** Yes, but it is not the same as accepting every principle. I myself do not read McNulty as suggesting that we have a major structural review. The recommendations set out propositions that I felt were very much aligned to the NAO Report. Those were about closer alignment, both of incentives and responsibilities within the industry, so if we set to one side the structure of Network Rail for a moment and assume you have an infrastructure company and train operating companies as you roll forward, what we believe is interesting is the opportunity to consider whether there is the chance for contestability and different arrangements on routes—whether we start with self-contained routes or geographical areas of the country. You can then start to have much more comparable information about the costs of operating in some parts of the system compared with others.

When we talk about structure, I myself do not read anything here as saying that we are going to have "son of Network Rail" or "son of TOCs". It is about taking what we have and making it work better. I do believe that will require more transparency of information, as the Committee is very keen to get; I also think it will require Government to be less interested in the detail of operation. We are in a position where, broadly speaking, within the franchises we currently let we specify station opening hours broadly in accordance with the station opening hours in 1996. That is an odd level of detail for Government to get itself into, and the approach that is being suggested puts us in a strategic, clear position where we say, "For this much money we want these things, and in the future those things need to include efficiency, safety and performance", and we then leave the regulator and the companies to drive that performance out as they know best.

**Q248 Chair:** But you are not looking at merging the infrastructure company with the operating company?

***Lin Homer:*** The Secretary of State has been clear that anything that requires legislative change is going to be so slow we are not going to hit the changes. He is encouraging the industry to look at ways that we can adopt these approaches without needing a new Bill, and therefore it is about how you set arrangements for different forms of integration within the broad structure we have.

**Q249 Chair:** Do you want to elaborate on that? It leaves me rather puzzled.

***Lin Homer:*** Only to say it is very early days. I realise the slight frustration: McNulty was not out the last time I was here; it is out now. We really, seriously regard the input from yourselves and the McNulty review as shaping the decisions we take over the next period. Pretty much all the major franchises are up for re-letting over the next couple of years and we are going into the next control period. We think there is an opportunity to build on what you have told us and what McNulty has and use that to shape the next iteration and next decade of the railways. It is quite early days to say what every page of not only the summary report but the other appendices that go with it will translate into in terms of actions. That is why we support the creation of the rail delivery group and why we are quite keen that over the summer we actually turn some of these high-level recommendations into actions.

**Q250 Chair:** Do you also accept from the work that we did on the East Coast Main Line that current arrangements do not really transfer risk sufficiently to the private sector companies?
***Lin Homer:*** As I have said, we believe that Government does hold to itself more of the detail and therefore more of the risk than it should. Yes, we are interested in learning how we can achieve more of that transfer.

**Q251 Stephen Barclay:** On that point: I think the Government does take more of the risk than was the evidence given at our last session. We discussed the termination clause of the East Coast franchise and I asked about additional revenue and you did not have the figures at the time. Just to recap, it was a £1.4 billion contract and the termination cost to National Express was just £120 million, which seemed a remarkably low figure. In terms of additional revenue support, you have now said that you gave £40 million in 2009–10 and £37 million in 2010–11 and you have not got the figures for this year. Am I correct in thinking that from that £120 million National Express have had £77 million extra from your Department?
***Lin Homer:*** Those were the subsidy for the other routes that they run.

**Q252 Stephen Barclay:** We looked at whether you took legal action against the other two franchises, and you took the decision not to as this was a standalone company. The termination penalty to the company of £120 million was actually, in practice, less than £50 million because they have gone on to have their other two franchises extended and to get extra money from the Department over and above what you were contractually required to pay.
***Lin Homer:*** We had quite a long debate about this last time I was here and we took the judgment taking into account not only the relationship with National Express but the behaviour of and impact on other franchisees. We took a view, which I believe the NAO agreed with us on, that taking a firm line with National Express in terms of terminating the agreement would prevent other franchisees walking away from their responsibilities. My memory is that we would have added something like £250 million to £300 million of risk in the other franchises if we had acted differently.

**Q253 Stephen Barclay:** Sure, but I am asking about this specific one. We had evidence the other week on the NHS IT programme where Government seems to have negotiated itself into a position where it is hugely costly to terminate a contract. We have Government on the other side here, where it is the standalone company wishing to terminate a contract. What I just want to confirm is that in essence they have walked away from a £1.4 billion contract, keeping their other two franchises on which they are making a profit, and on which in the first two years the Department gave them an extra £77 million. So the penalty for walking away from the East Coast was, in essence, less than £50 million. That is correct, is it not?
***Lin Homer:*** No, I think that is a simplification of a situation in which there was significant commercial and reputational damage to them by the termination that is a wider issue.

**Q254 Stephen Barclay:** If you say there was reputational damage perhaps you could explain this: I looked at the slides that the Finance Director of National Express put before investors—it is on the website if anyone wants to check—and in it they make a particular virtue of saying that the Department has assured them that they will be welcome in bidding for future franchises and there is no reputational risk. They are telling their investor relations that there is no reputational risk and they are making profit on their other two franchises and there is a good market here that they can go after, yet you are saying that from the Department's point of view, notwithstanding the extra money you have given them, the real risk for them has been reputational. It does not seem to stack up.
***Lin Homer:*** No, what I said is that it was more complex than you were suggesting. I do not believe that you can equate the contractual subsidies for the other two and take that sum off the penalty they paid. The question of the impact on them as a company is more complex than you were describing. Actually the impact on National Express has to be assessed not only from what they say on their website but what is going on within the company.

**Q255 Joseph Johnson:** What would you see as the reputational impact on National Express as having been?
***Lin Homer:*** I tried to put this into words last time. One of the things I would say is that the impact on the wider market is that we did not see any other franchisees—
**Chair:** That is not answering the question.

**Q256 Joseph Johnson:** What has happened to its reputation?
***Lin Homer:*** National Express has had some difficulties internally about their forward strategy, including what priorities they should follow through in business. That is widely known.

**Q257 Joseph Johnson:** No, but what about its reputation externally? Reputation is commonly understood as an external perception of a company.
***Lin Homer:*** It is known that we terminated the contract and that undoubtedly does have an impact on reputation.

**Q258 Chair:** What is the evidence?
***Lin Homer:*** There was impact on share price initially.

**Q259 Joseph Johnson:** So was there no lasting impact on the share price?
***Lin Homer:*** It would be difficult to sit here and suggest that a single action from Government should have a lasting and permanent impact; that would be a massive ask of any Committee. However, we do believe it was the right thing to do, and your own review by the NAO confirmed that. As I say, although you are putting it to one side, for us the other question was what the rest of the industry thought about their interactions with us. We had a number of franchises we believed were in similar difficulty and the rest weathered through. The net result of that, we think, was a good outcome for the Department.

**Q260 Austin Mitchell:** You said right at the start in answer to the Chair's question that you hoped the new contract you negotiated with East Coast, and presumably GWR and others, would give you better alignment between costs and responsibilities. What is going to be different in these contracts to the contracts that GNER and National Express had?
***Lin Homer:*** We are still working on the shape of the franchises. Part of the reason for welcoming the McNulty report at this point is that we have an opportunity to consider the messages from McNulty and to build those into our next franchising. We are working on the shapes of franchises. What we have said publicly is that we intend franchises to be longer, we intend them to be less specified as to the detail from us, and we therefore expect the commercial risk and the commercial opportunity to sit with the franchisees in a different way. We have indicated that we are prepared to look at a GDP rather than a cap-and-collar approach for the risk transfer. The Secretary of State has also indicated that he is prepared to look at—

**Q261 Austin Mitchell:** So the company will bear more risk?
***Lin Homer:*** And there is the possibility for the Government to share more benefit if significant profits over and above those anticipated at the beginning of the franchise are created, particularly by the greater freedoms that we give. We think this is a chance for quite different franchises in the future.

**Q262 Austin Mitchell:** You have given us the impression that the Secretary of State is brimming over with good intentions, which in a perfect world he would like to see realised, but he is not going to legislate for them because he does not want to involve new legislation. The McNulty report suggests bringing train and track operators together at route level in different operating models and to different degrees in different parts of the country. This sounds to me—a common sense kind of bloke—crazy. That would demand new legislation; you are not going to start moving in that direction and start dismantling Network Rail, are you?
***Lin Homer:*** It is one of the things that we are going to look at. We do not believe that Roy McNulty's suggestions all require legislation. So there are some areas where Network Rail and train operators have a shared route manager who effectively carries out responsibilities for both. We think there are some models within the existing framework where you could have greater integration or greater transfer of responsibilities between the infrastructure provider, maintenance provider and operation of the trains than we have had in the last period.

**Q263 Austin Mitchell:** Can you do that without legislation?
***Lin Homer:*** We think so, yes.

**Q264 Austin Mitchell:** Okay, but that effectively means that having started out with a unified system where British Rail did the maintenance and ran the trains, we then cut away into a separated system where there is Network Rail and somebody else runs the trains, and we are now going back to the original model of a unified system but on a local, patchwork basis.
***Lin Homer:*** This is why the report is worthy of some study over the summer and why we have not come out ticking one recommendation and crossing the next. I myself do not think that Roy McNulty is suggesting a pendulum swing from the unified structure to something that has no central strategic overview at all. What he is identifying, and I think the industry is recognising, is that there are some areas where the alignment of a major operator on a route is high and where you therefore may well want to delegate more of the routine maintenance and concession to that operator but in a way where Network Rail are choosing what to do, and you create that kind of localised area. I think there is a plan in the report but I am afraid that I could not point to the page instantly. He suggested in the report that Anglia might be an example and c2c is one of those quite specialised areas where you have one single operator using one line and the question of whether you could combine the activities more could be looked at.

**Q265 Chair:** So are you going to instruct this private company, Network Rail in East Anglia, to stop doing the maintenance and have it done by c2c?
***Lin Homer:*** The suggestion within the McNulty review—

**Q266 Chair:** Are you going to instruct them?
***Lin Homer:*** The suggestion within the McNulty review is that you could allow arrangements like that to happen.

**Q267 Chair:** What happens if Network Rail say, "Get lost."?
***Lin Homer:*** This goes back to the governance of Network Rail, but I believe that when you had the Chief Executive before you, he expressed interest in that model and he himself felt that there were benefits to be gained from it.
**Chair:** It is very muddled.
**Austin Mitchell:** You could get Mystic Meg as a consultant on this.
***Lin Homer:*** Sorry, I missed that.

**Q268 Matthew Hancock:** Sorry to cut across your final comment. I think there is a lot of merit in that as it happens: learning from where things have gone well in contracting in the past. I see that McNulty recognises that. There is a question that is slightly tangential to it, which is about trying to bring this back to getting better value for money, through both changes to contracting and the way that Network Rail is regulated more directly.

You talked earlier about aligning incentives and if that can happen that it would be very good. However, one of the things that I was very concerned about in the evidence from the Chief Executive was that he tried to explain why it is appropriate to specify inflationary increases in costs based on a very broad measure of inflation, including in areas where Network Rail does have the ability to control costs. I think we can all see how in areas such as the cost of fuel, that is outside of his control as he is not a big player in the global fuel market. However he is a big player in the domestic railway upgrades or railway servicing market—in fact he is a huge player—so he should have some market power ability to control costs. If you just assume an inflation rate then of course that inflation will happen because it is much easier to put a bit of inflation into your costs than not.

How are you planning to improve the incentives to get costs down by better assumptions about inflation, rather than making a very broad assumption that basically lets Network Rail off the hook?

***Lin Homer:*** I read the transcript and you had a fairly lengthy conversation about this point.

**Q269 Matthew Hancock:** Yes. Sorry, my question was very lengthy as well. I think it kind of gets right to the core of the incentives and where the costs come from.

**Austin Mitchell:** Use CPI, not RPI.

***Lin Homer:*** The ORR, in their first consultation of their periodic review that they have just published, do put out the question about whether they have got the balance of risk protection right as one of the consultation questions. They describe the main principle, which is used by all regulators, that as far as possible risk should be borne by the party best able to manage it. As you say it is unquestionably the fact that if you do not protect to some degree the elements outside their control you are simply creating more areas for reopened debates about cost drivers as you go through. However, they do say within their consultation that whilst for the period that we are just finishing they made estimates of input price inflation in their input efficiency assumptions, they question whether for the next period it would still be appropriate and how those input price movements should be reflected in the calculation of their efficiency. I think they have opened up the debate that you had with them about the right level of protection. There is a question about how you reach a balance on that that is not an attempt to become so detailed in tracking every individual piece of inflation that your indexation is just a morass of measurement, but how you might potentially chunk a number of input areas up into more or less controllable—

**Q270 Matthew Hancock:** There is indeed that question. What is your answer to it?

***Lin Homer:*** My answer, which you will not be happy with but I will say it anyway, is that I think it is a proper thing for the regulator to put in their consultation for the next period.

**Q271 Chair:** Can I just ask you a very simple question? You have just said to the Comptroller and Auditor General that you expect 30% real-terms efficiency gains by 2018–19. For heaven’s sake, surely if you are going to get anywhere close to that you have to look at the inflation rate as a starter?

***Lin Homer:*** Yes.

**Q272 Matthew Hancock:** Well, that is meaningless unless you have a decent hold on what “real” means.

**Chair:** Quite.

***Lin Homer:*** Yes, and I think it links to the question of understanding their cost base better and we should expect the next control period to have a look at that and to see whether we can find a more refined measure.

**Q273 Matthew Hancock:** The Department for Transport’s future budget over the Spending Review period is set in nominal terms and then you are saying to Network Rail that the amount you pay Network Rail is a real figure. You say it is not a subsidy but let’s not go into definition questions: it is a real figure so somebody has to take that cushion and you are just saying that some of these things should be considered. The amount of cash is not moving up and down. If Network Rail cannot deal with it then you have to, so why is it more appropriate for you to take that risk as a Department rather than Network Rail to deal with it?

***Lin Homer:*** I was heartened by the fact that the new Chief Executive thinks that he can drive cost out. That is what should drive us to try and agree an inflation index with him that is not unreasonable but that is as tight as it can be. That would give us all a basis to measure those efficiencies from what we felt more confident about.

**Q274 Matthew Hancock:** Okay, but what about the specific question? You have a nominal budget that you have to live within but if you give Network Rail real increases, unless you define real in a very narrow way, then you have a cushion that you are not in control of, so you have to manage the risk. Why are you better placed to manage the risk, according to the principle you set out earlier, than Network Rail?

***Lin Homer:*** Because we have a statutory duty to be the provider of last resort.

**Q275 Matthew Hancock:** Yes, but if you provide it to Network Rail because Network Rail allows their costs to rise, then you cannot provide it to somewhere else, like dualling the A1307, which is absolutely vital by the way.

**Mr Bacon:** Although it is not as vital as the A140.

**Q276 Matthew Hancock:** I am sorry, I was flippant—well, I was not flippant, it is extremely important, but let us go back to the question. The impact of cost inflation has to lie somewhere. You are not as good as the Chief Executive of Network Rail

in terms of getting to grip on their costs because he is independent, so why allow him this flexibility of allowing his costs to go up and saying that you had better give them some more cash?
***Lin Homer:*** The reason is that it is a regulated industry and we do not simply allow them to pass over any cost to us that they fancy, so it is not quite as you describe. The cross-questioning you did of Bill Emery and David Higgins when they were here was on whether the inflation base from which the efficiency deal was struck for the last occasion was as tough as it looked. That was the nub of your question and what I am saying to you is that I think it was right for us to look, for the next period, at whether we can make ourselves more confident that we have the right level of risk protection but not over-soften that so that what we ask of them is easier than it should be.

**Q277 Matthew Hancock:** Do you accept that if you do not pass that risk on to them, then you hold it?
***Lin Homer:*** Then it sits with me, yes.

**Q278 Chair:** Can we now move to regulation? Before we move on to the regulator and his organisation, can I just ask you how many people in the Department for Transport work on Network Rail issues?
***Lin Homer:*** I am sorry, I think it probably depends on definitions. If you asked me how many worked on rail I guess we would have several hundred people who work on rail. That would be the full range of rail, so that would include the people who commercially manage the franchises through to the people that do rail policy.

**Q279 Chair:** Would you be able to give us a note within a week?
***Lin Homer:*** I can give you my organisational structure and show you which parts of that relate to rail, yes.

**Q280 Chair:** I am trying to get at duplication.
***Lin Homer:*** Yes, I understand.

**Q281 Chair:** Do you know how much you spend on consultants as a Department on supporting your work with Network Rail?
***Lin Homer:*** Not off the top of my head, no.

**Q282 Stephen Barclay:** Are you providing that to the Cabinet Office on a monthly basis now?
***Lin Homer:*** Yes, we publish our consultancy figures overall and the figures have gone down markedly since the election, as you probably all know.

**Q283 Chair:** Can we have a retrospective note going back a few years on how much is spent on consultants by the Department in supporting the work on Network Rail, going up until April of this year? That would be helpful.
Now, do you agree with McNulty on integrating the regulation of infrastructure and operating companies? Do you agree with him on that?
***Lin Homer:*** We do agree that we should look at the role of the regulator.

**Q284 Chair:** Do you agree that they should be integrated?
***Lin Homer:*** We do agree that there should be more clarity between our role and the role of the regulator.

**Q285 Chair:** I am really trying to ask a very simple question. Are you saying you do not think they should be integrated or you do think they should be integrated?
***Lin Homer:*** Yes, and we agree with McNulty's point that you have to move towards that at a pace at which the regulator is able to take on the new responsibilities, so he links it to a capability point and a timing point. That was my caveat, Chairman.

**Q286 Chair:** We had a not very happy session with the regulator and it seemed to us that whether you looked at his ability to control salaries and bonuses, his ability to control costs, or his ability to extract relevant data from Network Rail so that there could be a better understanding of what drove costs, the regulator had not been very successful. Do you agree with that judgment?
***Lin Homer:*** I think the regulator has achieved quite a lot alongside Network Rail, but I believe we should expect more of them in the future. It is very difficult to dismiss all that has been achieved in the last period as inconsequential, but I myself believe that the regulator should be delivering more and should be helping Network Rail.

**Q287 Chair:** I know it is a very boring graph, but this shows that relative efficiency got a little bit better from 1995 to 2000 but was at an all-time low in 2006. I am not sure what was achieved if the relative efficiency of Network Rail over that period deteriorated to such an extent, or how you can sit there and say things were achieved.
***Lin Homer:*** The regulator has a wide range of responsibilities, and during the period we are talking about huge improvements were made on performance, significant improvements were made on capacity, and continued and significant improvements were made on safety. One has to put the credit for those somewhere.

**Q288 Stephen Barclay:** But the budget went up massively, so you would expect improvements. The budget went up by 60%, and if your budget goes up by 60% one would expect improvements.
***Lin Homer:*** Hence my expectation that we add value for money to that agenda going forward. If you think back to where we were a decade ago there were some very important required focuses on ensuring the infrastructure was maintained safely, that performance was delivered and that capacity was increased. There is a very interesting chart that is rather more impressive than the cost one about the turnaround on the use of the railways over this period. What we are now asking of ourselves in the next period is that, instead of jumping from one focus, and something going off the boil whilst we look at it, we hold the progress we have made on performance, improving capacity and safety, and we add improving performance in value for money.

**Q289 Chris Heaton-Harris:** I was interested in what you said earlier—that we have one of the most heavily regulated rail industries across Europe. Across Europe there is no direct comparison that you can make as there is no country that has a regulator as we have it structured, so where is our model coming from? Looking at best practice across the Channel, where are we taking inspiration from or are we just making this up as we go along?
***Lin Homer:*** We have a regulation model in a number of our infrastructure provisions, so we have some similarities in regulation of our utilities and regulation of rail. We take a basic set of principles from that. We are interested in what happens in the rest of Europe but I have to say that they are also interested in what we do, so there is probably equal trade both ways in terms of learning from each other. There are quite substantial differences, which both your own reviews and McNulty's have brought to light, in the way railways are run, so in some other countries different portions of the railway are more or less controlled.

**Q290 Chris Heaton-Harris:** So our regulator has unique powers that other rail regulators, where they exist, do not have?
***Lin Homer:*** Yes.

**Q291 Chris Heaton-Harris:** And these have been added on over a period of time. Are you looking to review exactly how the regulator takes these responsibilities on into the future?
***Lin Homer:*** Yes, hence my slightly uncertain answer to the Chair, which was neither yes nor no. We are interested in greater clarity about the regulator. We do not think that means you simply keep adding things; we think you have to have a look at the basket of regulation and make sure it makes sense when you put it all together. I would say that the UK's regulatory model is probably one of the most developed in Europe and there are many elements of good practice to that. It does not mean we should not look at it and try to improve it further.

**Q292 Chris Heaton-Harris:** So when you talk about the fact that we are one of the most heavily regulated in a European context, is that a good thing?
***Lin Homer:*** No, I was slightly trying to counterbalance the conversation from the Committee that they should be regulating more firmly.

**Q293 Chris Heaton-Harris:** I am not convinced that was where the Committee was going.
***Lin Homer:*** I was trying to put that on a spectrum. I think what we should be aspiring to is regulation that is impactful without being bureaucratic. That is easier to say than to do, I suspect.

**Q294 Jackie Doyle-Price:** You mentioned a couple of times the overlap between the role of the Department and the regulator, which is interesting because really there should not be one. It is the Department's role to set the vision, strategy and outcomes that we want the rail system to deliver, whereas, as you mentioned, you have been bogged down in things like safety and capacity, which is really the role of the regulator. McNulty picks up on the fact that there really needs to be more clarity. Could you set out and define what you think the role of the Department is, as opposed to the regulator, and where you think the overlaps have occurred?
***Lin Homer:*** The Department has ended up being involved in a level of detail about the operation of rail. There are all sorts of reasons for that and these things happen over time, but we have probably not stood far enough back and asked ourselves what we are trying to achieve, how and in what timescale. We are a major provider, we have a high-level output specification that we agree with rail on a regular control period basis, and we should probably spend more time being clear about what we are buying with our money for that period and less time working out what that means about how many times the train stops at a particular place, when the station is open and whether there is catering on the train. In a way, that is unfortunate. Those issues are a bit of a British obsession and so the Department has become more embroiled in those things than is sensible.

**Q295 Jackie Doyle-Price:** In terms of behaviour change from the players involved in this, would you say that the Department has probably got the biggest challenge? Really, that is a reflection on paragraph 18 in the summary of McNulty, where he says he has not drawn a conclusion as to whether it is the industry's culture that causes a lack of leadership or whether lack of leadership has contributed to the problems in the culture; on balance, he thinks the latter explanation is likely. Is that not a fairly damning indictment of the role of the Department in setting that strategy and setting that leadership here?
***Lin Homer:*** I think that paragraph is about the industry and what McNulty is saying is that there is a lack of leadership within the industry. I think the Department has a great deal of capacity to improve rail and I think we are more likely to do that well if we stay in the strategic area. I think the Department has done very well to keep rail on an improving trend on some of its axes over the last period. What we have to really focus on now is staying in that strategic space. That should be what gives us the capacity to think about cost, performance and safety all at once and not get dragged down into the detail that I think we sometimes have, so I do accept that there is a major change for us.

**Q296 Jackie Doyle-Price:** To be fair, it is not difficult to see why this has happened. Within the industry, there have obviously been some pretty seismic shocks. It is the natural business of Government to want to deal with the problems and the outcomes caused by that. What I want to get across is whether the Department has recognised from this that it is time to get back to strategy and not about micromanaging?
***Lin Homer:*** I think we have, although it is still quite a big change for us to make that real. This is one of those issues of habits, isn't it? Through the new franchising, we are going to have to create new habits for ourselves as well as the industry that do not have us sliding back into micromanagement. I have no

doubt about that. Changing your habits is a bit more difficult than just recognising them.

**Q297 Stephen Barclay:** Can I just ask about direct agreements between Network Rail and funders? What will the role of the regulator be in direct agreements moving forward?
***Lin Homer:*** Sorry, between Network Rail and the operators?

**Q298 Stephen Barclay:** We had evidence from the Rail Regulator who wanted further powers. Bill Emery said, "We believe that we should have a greater involvement" and went on to say, "At the end of the day it is a matter for DfT". You are here to speak for the Department for Transport; what role will the regulator have in direct agreements?
***Lin Homer:*** This is a detailed version of the question the Chairman asked me. We do believe that we should move out and give the regulator more space. There is a debate about the pace and the nature in which we go forward on that but that is what I think we should be working for in the next control period.

**Q299 Stephen Barclay:** It is very hard to get any specifics. I do not know if other members of the Committee feel the same but what you are saying is that you will look at it. It strikes me that we know what the issue is and the regulator said they want further power. When are we as a Committee going to be able to get visibility on whether they will have changed powers or whether it is going to be broadly more of the same?
***Lin Homer:*** You have to allow the Government to make policy in this area. Making policy is theirs and McNulty is still relatively fresh. I tried to say earlier that I do understand your hunger, we are interested in this too, but it would be wrong of me to pre-empt the policy period that the Government has got over the summer and try and guess the answers the Government will reach over that period. The Ministers will look at those policy issues and will reach decisions, and I am sure that will generate a further conversation with you in due course.

**Q300 Stephen Barclay:** As Accounting Officer, how do you assess the competence of the regulator?
***Lin Homer:*** We have to pay regard to your Reports on the regulator and to our own experience, and we have to make judgments. I have already said that I believe we can and should expect more from the regulator going forward. That is not the same as deciding policy changes on the hoof that will change the balance of the regulator's position.

**Q301 Stephen Barclay:** Again that answer suggests that you assess the competence of the regulator in large part from looking at the NAO Reports. One would have thought that the NAO Reports on Network Rail would help inform that and give a fuller picture than is the case at the moment. What I do not get is what the metrics and assessments are on which you base an assessment of the competence of the regulator, whether they have the competence for any changes you are seeking to require from them, or indeed whether it is just going to be more of the same, and whether you think they have performed well in their duties to date.
***Lin Homer:*** We assess the competence by measuring what they set out to achieve for each control period and how much of that they achieve. We assess the competence by making a judgment. I think it is perfectly reasonable for me to use the NAO as part of that judgment as to whether they have been challenging enough with themselves and with Network Rail about how far they have got. One is relatively simple: "We said in this control period we would do the following with them, either we have or we have not". Secondly, there is an aspiration point and that goes back to the inflationary point we discussed earlier.

**Q302 Stephen Barclay:** It is just that on bonuses they are ignored, on costs we are significantly higher than elsewhere in Europe, there is a major gap in terms of efficiency and the data with no timescale as to when that is being closed, and on things like compromise agreements they do not even request the data. So I am just trying to get a handle on what the metrics are on which you assess their competence.
***Lin Homer:*** I will repeat what I said earlier. During that period there were very specific aspirations that were delivered on performance, safety and investment, a number of which were hit. One can always talk about the ones we want to do more of, but you have to balance that out with what has been achieved in the last period.

**Q303 Chair:** Amyas?
***Amyas Morse:*** I have not had a chance to meet the new regulator yet but the Committee has had a chance to meet the new Chief Executive of Network Rail, who came across as a very capable and formidable person, as he had also struck me as being in his previous role. In a number of answers, you have said that it is up to the regulator, and I think you need to make sure that the regulator is sufficiently fortified to be in a position that he does not find himself being overwhelmed by a very forceful and visionary Chief Executive of Network Rail. Forgive me, but I really think one needs to consider that quite carefully when putting such a heavy burden on the regulator.
**Chair:** I am trying to draw this to a close, so I am taking that as a comment.

**Q304 Austin Mitchell:** I have a comment as a rail traveller. Are we ever going to get to a point where the costs of getting to the best parts of this country, say Yorkshire and Humberside, are comparable with those on European railways? Are we ever going to get that level of equality?
**Chair:** Just say yes.
***Lin Homer:*** Shall I say I will do my best? Truthfully, there is a difference in the costs you can achieve on some types of rail versus others.

**Q305 Austin Mitchell:** This is a small, overcrowded country; rail should be cheap.
***Lin Homer:*** We should be able to achieve 30% efficiency over the period we are talking about. That

should be good for passengers as well as the taxpayer. That should be a common aim for all of us.

**Q306 Austin Mitchell:** It is now cheaper for me to go to Hungary or Crete than it is to go to Leeds.
***Lin Homer:*** It depends on the ticket you buy and when you buy it.
**Austin Mitchell:** Of course, of course.
**Chair:** Right, I gave you a chance Austin; let's move on.
**Matthew Hancock:** At least Austin has the ability to buy an old age pensioner's ticket.
**Chair:** And long may that continue.

**Q307 Matthew Hancock:** For some of us, it is even more expensive.
My final question is on this 30% cost reduction. What will happen if that is not there?
***Lin Homer:*** If you are all still here and I am still here, you are going to be very cross with me, so that will be one thing. Personally I think we should not take control periods as things where we start them and do not do anything until the end of them. If we do achieve the greater transparency of information that I think both you and we want, we should know the progress we are making against that control period as we go forward. You should expect me to work with the regulator. I totally accept Amyas's point, which is why I made the point about capability. You should expect us to make changes as we go along that increase the chances of landing that, rather than see it as a one-off aspiration we do not look at for five years, and you should hold me to account for that.

**Q308 Chris Heaton-Harris:** I am just wondering if we will get a new standard of transparency when it comes to HS2. Is that going to be a new model for us, especially on the value-for-money aspect of it? I very much look forward to being able to read a National Audit Office Report on HS2 and the consultants in the near future. That is more of a point.

**Q309 Chair:** Lin, it would be really helpful if you are able to answer this directly, if you cannot then you cannot. There are clearly huge challenges for you and you partners here. There are challenges to deal with structural change, if you are going to take any of the McNulty recommendations. There are challenges to drive these cost efficiencies. There are challenges to get proper incentives into the system, which do not exist at the moment. There are challenges to deal with increased demand at a time of tight fiscal constraint. There are also challenges on improving regulation, which we have just talked about. You have a big agenda before you. Can I just ask you: when will the public start seeing evidence of change?
***Lin Homer:*** I think that by the start of the next control period, which is 2014, we should have in place the arrangements that will start to show the difference for each year of that control period. That does not mean nothing will happen between now and then.

**Q310 Chair:** So 2014 will just mean systems will be in place. What I am trying to drive at, and it has been a frustration in the evidence that you have given today, is when is something actually going to happen where we can look at it and say, "That has changed for the better"?
***Lin Homer:*** I think you will see changes in the system from as early as next year, but those will be the beginning of the changes that will build. I am confident that, if you have me back next year, and I am sure you will, that we will be able to talk about practical things that we are doing differently on the ground.
**Chair:** Okay, thanks very much indeed. Thank you.

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## Written evidence from Network Rail

### CABLE THEFT

At the hearing on 11 May, Nick Smith asked David Higgins (Q100/Q101) about the impact of cable theft on Network Rail. It is hoped the following information provides useful background for the Committee on this issue:

- The impact of criminals targeting the cables which control vital rail infrastructure such as signals and points has been extremely significant for passengers, companies moving their goods by rail and Network Rail itself.
- The railway is designed to "fail safe". If an act of cable theft or other serious fault is detected on the line, trains are stopped until a safe method of working is implemented or the fault has been repaired. In extreme cases this can take several hours.
- In 2010–11:
  - £16.5 million was lost through cable theft (almost £43 million over the the last three years)—both in terms of replacement costs and compensation paid to our customers for delays caused by these incidents.
  - There were nearly 1,000 attacks on essential rail systems—a 52% increase on the previous year.
  - Passenger services were delayed by more than 6,000 hours (and more than 16,000 hours over the last three years).
  - British Transport Police recorded around 3,000 crimes and made more than 900 arrests.
- The worst affected areas include Yorkshire, the North East, East Anglia and South Wales.

— Network Rail is working closely with the British Transport Police (BTP) and other companies that suffer in a similar fashion, including BT Openreach and energy companies, to deter thieves and prevent ongoing disruption.

— Methods used to deter and catch the thieves include:

  — BTP has set up a dedicated task force, increased patrols—for the BTP cable theft is a priority second only to terrorism.

  — Network Rail has recently funded extra, dedicated officers to support this.

  — Partnership with Serious Organised Crime Agency (SOCA).

  — National intelligence cell with members from BTP, Network Rail and non-rail partners.

  — Use of the helicopters, CCTV, forensic marking, trembler alarms and other devices to protect the cable.

  — Fast response teams to get trains on the move as quickly as possible.

  — Introduction of new type of cable that is easier to identify and harder to steal.

  — Use of approved scrap yards for disposals of used materials.

*May 2011*

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**Further written evidence from Network Rail**

I would be happy to give a commitment to disclose future compromise agreements to DfT. However, in doing so it would imply a change in relationship, and respective accountabilities, between Network Rail and HMG. There would be advantages, but there would also be disadvantages. I don't believe therefore, that it would be appropriate for Network Rail to make this decision. If DfT, or ORR, wishes to take the policy decision that it should have oversight of, and by implication a degree of accountability for, the use of compromise agreements, then I would be content to comply.

*May 2011*

**Annex**

ADDITIONAL INFORMATION FOR THE COMMITTEE

*Q215 Whether Network Rail's debt is guaranteed by Government*

The financial indemnity in respect of Network Rail's debt is between the Secretary of State and Network Rail's lenders. The indemnity is an irrevocable obligation on the Government to make payments to Network Rail's lenders should the company default on any of its loan obligations to those lenders. At present all debt held by Network Rail is covered by this indemnity.

*Q233 The total value of the compromise agreements entered into by Network Rail*

The Department for Transport does not hold information on the total value of the compromise agreements that Network Rail has entered into with former members of staff. Such agreements are confidential arrangements between the two contracting parties.

In light of the public interest in the value of Network Rail's compromise agreements following the recent report on allegations of impropriety at Network Rail, I have asked David Higgins whether he can provide the Committee with more information on this matter.

*Q279 The number of people who work within the Department for Transport on Network Rail issues*

There are two members of staff within the Department whose duties primarily relate to the sponsorship of Network Rail. These staff are responsible for making grant payments to the company, responding to Parliamentary and public enquiries on the company, managing issues arising from the relationship between Government and the company and overseeing the Government's interest in propositions relating to the reform of the company. A number of other staff from the Department for Transport's Rail and Finance Directorates work on Network Rail related issues on an ad hoc basis, as part of their wider duties.

*Q284 How much has been spent on consultants by the Department for Transport in supporting the work on Network Rail, going up until April 2011*

The majority of the Department's consultancy spend relating to Network Rail was incurred by Sir Roy McNulty's Rail Value for Money Study, which wasco-sponsored by the Department and the Office of Rail Regulation. Sir Roy's study team spent a total of £2,063,094 on consultancy, although a proportion of this spend related to rail service operations and other matters not directly connected with Network Rail.

In addition to consultancy spend on Sir Roy McNulty's study, the Department has incurred consultancy costs relating to Network Rail of:

| | |
|---|---|
| 2008–09 | £115,511 |
| 2009–10 | £68,158 |
| 2010–11 | £79,279.5 |
| 3 year total | £262,948.5 |

Printed in the United Kingdom by The Stationery Office Limited
07/2011 012200 19585

ISBN 978-0-215-56050-6

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PEFC/16-33-622