

PROJECT ARIEL : whether and how to restructure the industry

Questions to be addressed by advisers with evidence and analysis

Notes

- Assumes no need to revisit decision to remove from Railtrack exclusive right to own and manage major enhancement projects, but all options should be reviewed to assess any implications on enhancements
- There is an inevitable focus on Railtrack but it may also be useful to look, especially in the context of the vertical integration/regionalisation option, at the financial robustness, incentive structure and service performance of the TOCs
- The work in the first two categories of questions has been done in the main but not taken to its logical conclusion and structured to help make decisions

Catalogue the symptoms

- Service provision
 - Railtrack
 - TOCs
 - Safety record
- Management of the core infrastructure
 - Poor maintenance
 - Railway engineering expertise gap – in Railtrack and the industry
 - Pass the buck/blame culture
 - Delays in improvements eg in approving safety case for new rolling stock
- Financial status including immediate fund raising problems and poor ratios and high cost of capital (uniquely, higher than return on capital) of Railtrack, current and projected based on various assumptions of regulatory settlements
 - ⇒ *What is the realistic settlement eventually that will put Railtrack on a sound financial footing and restore finance worthiness and how much funding will it divert from enhancements*
- Annual/regular reopener rather than 5 year regulatory settlements
- (Dys)functional regulatory relationships
 - Confusion about lines of responsibility
 - Lack of adequate strategy from SRA and lack of grip on unfolding reality of financial and service situation by ORR
 - Political interference without effective understanding or levers to incentivise performance ("the management of Railtrack spend more time watching Ministerial movements than the management of BR ever did" quote from industry observer)
- ⇒ *When are the next set of crises?? Is postponement or no restructuring an option??*

Link symptoms to root causes

Need greater clarity for Ministers in separating causes from the symptoms eg is management a symptom or a root cause, recognising of course the line is blurred

- Incentives driving each player resulting from incorrect assumptions about industry at privatisation and made worse by regulatory, political and industry actions since
 - Anticipated long term decline rather than growth in demand making no allowances for growth in capacity or the true cost of Operations, Maintenance and Renewals (OMR)
 - Lack of knowledge about return on capital employed from business lines, commuter rail, intercity, regional and by TOC franchises so cannot accurately assess value, target subsidy and incentivise industry properly
 - "Railtrack can earn greater returns by selling pathways and lobbying Government and ORR than by focussing on their core business"
- Original financing structure and (under)capitalisation
 - (In)adequacy of equity cushion relative to take enhancement project risk
 - (In)adequacy of Regulatory Asset Base (RAB) relative to current and forecast OMR costs; benchmarked roughly across utilities and other railways; against replacement value would also be a rough guide
 - Historic underestimation of cost of both OMR (for static and increased usage??) and enhancements – *what is the estimated realistic cost of Railtrack settlements and how much of that is a result of inaccurate historic assumptions and new safety requirements, therefore here to stay, and how much can be managed down with a better structure that results in better cost management and improved service from better incentives and/or lower costs of financing?*
- (Lack of) Risk transfer
 - Identify what risks have been or could have been transferred under a non-traumatised Railtrack
 - Would the RAB relative to enhancement and OMR costs ever have sustained risk and equity return?
 - Effective underwriting by the regulator of Railtrack's financial status, underperformance and state of assets risk
 - Is it possible to underwrite the rail system but not Railtrack shareholders under the existing financing framework or a reformed one? Is the remote threat of step in adequate? Will a more realistic level of capitalisation and RAB change this situation?
 - *If there is and can be no risk transfer and no growth story from enhancements (plus no competition) is there a role for private equity which is defined by risk, reward and pressure to compete? Does the equity return incentive in this case simply*

distort management incentives and shareholder scrutiny away from performance?

- Fragmentation of track and operations
 - Incentive structure in relationship between Railtrack and TOCs; is the recent change in access charges giving Railtrack some upside enough to align its interests with the TOCs in increasing service provision – what is relationship between marginal OMR and increase in usage - is cost of maintenance resulting from increased service provision disproportionate so interests can never be fully aligned?
 - Can the consequences of this fragmentation be dealt with contractually, financial incentives, governance and consultation structures, or does it need ownership and structural changes
- Lack of competition in infrastructure ownership
 - Is lack of competition in infrastructure ownership a crucial underlying cause of Railtrack dysfunctionality or nice to have?
 - Would competition have unintended consequences in terms of even more complicated interfaces with legally driven relationships between specific and single interest parties
 - ⇒ *Where do these two linked issues rank relative to other underlying causes if there needs to be a trade off between causes that can be addressed through restructuring - a function of severity of impact, extent to which symptoms can be addressed through non structural means and level of unintended consequences?*
- Regulatory structure
 - Regulatory settlement structure including circularity of having to take account of Railtrack's financing capacity in settlement
 - Whether attempts to recover full economic cost of under performance (tougher than other utility regulation) is counterproductive – by attempting transfer too much risk transfer none
 - Accounting treatment and WACC falling between the two stools of enhancement and OMR returns?
 - Is there a real role for SRA? Is its separate existence from ORR and the DTLR helping or harming the industry?
 - Why has ORR performed so badly? Is there an underlying cause or an issue of personal capacity?
 - Is industry over regulated and causing stifled initiatives, recruitment problems and distorted incentives
 - ⇒ *Is it realistic and optimal to carry on with current individuals and separate roles?*
- Current trauma in industry (not a historic root problem but may now have effectively become a barrier in the same way)
 - Current gearing and inability to raise equity from the market
 - Market perception/pricing of risk > other regulated industry despite risk transfer being lower
 - Is genuine risk transfer possible under the status quo in light of historic settlements and involvement of Government
 - Spiral of poor relations with Government and regulators

- Public confidence difficult to recapture
- Risk aversion on maintenance leading to unsustainable base costs and poor service
- Management
 - was this just the wrong people and the wrong time or is a matter of getting the right incentive structures in place?
 - Can we create adequate railway engineering capacity in medium term and redress industry skill shortage

Options:

What does each option look like in detail?

Which underlying cause(s) does each option address?

What are the implementation issues and what is the route map to implementation (need legal advice)

On a separate stream does the regulatory structure need to be dealt with under all the options

- Status quo reform: deal with overgearing; enforce Railtrack management change; new SRA chairman and directives; consider ORR merger in 3 years; manage to persuade HMT to fund the bottomless pit!
 - Is this viable, leave alone optimal?
 - What is the cost in terms of value for money and service provision relative to other options considered including after costs of disruption?
 - This becomes the benchmark "private sector status quo comparator"
- Take over
 - What is the minimum that would be required to enable this: eg recapitalisation and inflation of RAB; improved Railtrack TOC relationship; reform of regulatory structure and functionality of political relationship
 - Can we adequately deal with the separation of assets and operations through another means given poor state of infrastructure?
 - What is the cost in terms of value for money and service provision relative to other options considered including after costs of disruption?
 - Is this an implementable option? Is a consortium likely and could we be involved in engineering it? Would it require an insolvency situation or better engineered trough acquisition?
- Vertical integration
 - Are we talking about an equity model? In which case can we get risk transfer and adequate incentives for OMR?
 - Are the TOCs up to this? Would they undertake OMR better and more economically?
 - Is this an implementable model including in terms of reduction of franchises and regionalisation? Does it fit with franchise model?

- What is the cost in terms of value for money and service provision relative to other options considered including after costs of disruption
- Renationalisation
 - Can we engineer the solution through insolvency – finding the balance between not having triggered it and therefore avoid compensation of Human Rights Act but enough to be seen to have acted decisively rather than reacting to a failed privatisation that we refused to see and deal with earlier¹. Need detailed legal advice
 - How would we manage it?
 - Can we adequately deal with the separation of assets and operations through another means given poor state of infrastructure?
 - What is the cost in terms of value for money and service provision relative to other options considered including after costs of disruption. This becomes the pure “Public Sector Comparator” – subjective management efficiency assumptions needed for each option
 - What is the impact on PPP policy and market confidence especially if insolvency rather than compensation route uses?
- Not for profit trust model
 - Same issues apply as in renationalisation but with possibly greater chance of getting it managed properly
 - PSNB issues of debt raising

Selection Criteria for options

- What causes does it tackle – will it ensure the service provision and provide vfm
- Is it implementable and can we have a plan ready in time
- Handling issues – political and market impact

By way of example only and not comprehensive list of criteria (not least because I have reached limits on Word skills) we need to be able to see clearly the options against various criteria – if we had greater certainty on implementation routes, costs and albeit subjective judgements on vfm and service delivery:

	Risk/incentive Service provision	Cost/Vfm	Certainty/ implementability /disruption	Fragmentati on Competition	Handling
Status quo	No	No:[likely numbers]	Yes on disruption	No	Not really

¹ Should we be approving Renewco at this point in time when it could enable Railtrack to avoid insolvency for a while and rob us of a cleaner insolvency trigger than we might get for a while – including one in which we are sent to be in driving seat

			No on certainty of deliverability		
Take over	Possibly but at a large premium	Possibly but depends on premium [likely savings]	Risky implementation	No but might be able to engineer contractual improvements	Tricky
Vertical integration	[[No]]	Unlikely	Risky implementation and disruption	Yes	Yes but need handling if based on insolvency
Renationalisation	Yes because we acknowledge reality No because we carry the risk	Unlikely	Depends on insolvency trigger	No but might be able to engineer contractual improvements	Yes but need handling if based on insolvency
Not for profit	Yes because we acknowledge reality – the rest depends on whether we can get management structure right	Possibly but depends on management structure [likely savings]	Depends on insolvency trigger	No but might be able to engineer contractual improvements	Yes but need handling if based on insolvency