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## **Memorandum of Evidence**

### **House of Commons Select Committee on Transport, Local Government and the Regions**

#### **Transport Sub-committee Inquiry into Passenger Rail Franchising**

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1. This memorandum reviews the reasons for the failure of the Strategy Rail Authority's (SRA) refranchising strategy, comments on the Department of Transport, Local Government and the Regions' (DTLR) draft policy statement, and, in the light of the decision to halt the current process, makes a series of recommendations as to how to deliver improved performance and investment in the railways.
  2. The SRA was set up to deliver the policy objectives set out in the integrated transport policy White Paper, 'A New Deal for Transport: Better for Everyone', July 1998. That paper marked a radical departure in policy, in so far as the government aimed to engineer a switch from roads to rail transport. Previously, under the Conservative government, the policy objective had been to achieve a break-even railway, and allow the market to determine the passenger and freight balance between the two modes of transport.
  3. The SRA's analysis of the problem facing the railways in delivering this objective (rightly) focused on investment, and it was quickly recognised that, because Railtrack was a relatively small company, its balance sheet was unlikely to be able to carry the borrowings that would be required. Therefore
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(mistakenly) the SRA turned early on to the train operating companies (TOCs) as an additional source of investment finance.

4. Encouraging the TOCs to invest led in turn to an increase in their functions. TOCs were encouraged to invest directly in infrastructure and infrastructure projects, and the SRA indicated that the ‘reward’ for such investment would be longer-term franchises.
5. The SRA’s strategy towards refranchising naturally encroached on the responsibilities of Railtrack, whose task had been to maintain and enhance the rail network, in a fashion similar to the functions of NGC in electricity and Transco in gas.
6. Confusion created by a lack of clarity over roles and responsibilities was further exacerbated by the overlapping regulatory jurisdictions. It was the job of the Rail Regulator to oversee Railtrack’s activities, and in particular, to set the track access charges (TACs). To do this, the Rail Regulator needed to form a judgement about Railtrack’s investment programme.
7. The result was one of stalemate. The TOCs did not know what Railtrack’s investment programme would comprise, so they were uncertain on what basis to bid. Railtrack did not know how much of its investment requirements the TOCs would put in their franchise bids. The SRA did not know how much investment the Rail Regulator would approve, and the Rail Regulator did not know what the content of the SRA strategic plan would be.
8. This confusion was exacerbated even further by uncertainty about the commitment of the government in general and the Treasury in particular to

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providing the necessary financial support. ‘Transport 2010: The Ten Year Plan’, published by the DETR in July 2000, was far from a bankable commitment by government, and, in any event, the numbers were at best ambiguous. In the event, decisions by the Rail Regulator pre-empted some of the funding which was expected to be available to the SRA.

9. Notwithstanding these difficulties, the SRA pressed on with its refranchising programme without addressing the flaws in its approach. As a result, there was no clear basis for comparing one bid with another. By asking bidders to come up with ‘innovative ideas’ and ‘commitments to invest’, it was inevitable that low-cost/low-fare options would compete against high-cost/high-fare ones. With no criteria to make such comparisons, disputes over the awards of new franchises were inevitable, and, had the process not been halted, legal challenges were likely, somewhat similar to those that marred the lottery bidding process.
10. The Secretary of State’s decision to halt the refranchising process was therefore a timely move to limit the disputes which might follow, and to bring the SRA’s flawed approach to an end.
11. Having drawn the proceedings to a temporary halt, the Secretary of State now has an opportunity to provide a coherent basis for refranchising. Notwithstanding the claims made by some of the bidders, investment in rolling-stock is not dependent on the life of the franchise. Indeed, protection for what might otherwise be stranded assets in the event of the loss of franchise is provided through Section 54 agreements.

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12. There are two prior issues that need to be addressed before the refranchising can be carried out on an efficient and orderly basis, and competition for franchises can provide value for money and better performance. These are: to decide who is responsible for what; and to provide an investment framework for the industry.
  13. First, the government needs to decide where the responsibilities for the rail infrastructure lie as between Railtrack and TOCs. This is a matter of both principle, and of practical management and finance, and it admits of several possible solutions, including the privatisation model (with Railtrack solely responsible) through to a mixed model (which the SRA promoted), to finally a reintegration of track and train operations, perhaps on a regional basis. It is beyond the scope of this memorandum to discuss the pros and cons of each. But what matters is that a decision is made *before* further bids are invited for refranchising.
  14. Second, the SRA needs to set out a clear set of principles and a common basis for tendering. Instead of asking the TOCs to come up with ideas, it should itself provide a proper strategic plan for the development of the railways. This indeed was one of the primary purposes in setting it up and which it has so far failed to deliver. The 'Draft Directions and Guidance to the SRA' are a step in this direction, but much detail remains to be provided.
  15. In addressing these two issues, the government needs to have in mind the institutional structure within which the future direction and regulation of the industry is set. The conflicts and overlapping responsibilities of the SRA and

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the Office of the Rail Regulator (ORR) need to be resolved. Whereas, according to the traditional utility model, a railway industry financed independently from government out of the farebox might have lent itself to one left to a Rail Regulator and ORR, the post-White Paper world of continuing government support and the objective of expanding the share of rail against roads, requires a rather different institutional structure. As soon as practical, ORR's functions should be merged into the SRA, and the post of Rail Regulator abolished.

16. It is therefore concluded that:

- the government's draft policy statement on passenger rail franchising, has rightly drawn a halt to the ill-conceived approach to refranchising hitherto adopted by the SRA;
- the use of short-term extensions to franchises will not necessarily reduce investment in new rolling-stock;
- the government should use the pause in the refranchising process to address the key issues of the allocation of responsibilities for rail infrastructure between the parties, and decide whether, and to what extent, vertical integration is to be facilitated;
- the SRA should set out clearly the principles and common basis for future refranchising tenders, in line with the Draft Directions and Guidance;
- ORR's functions should be merged into the SRA and the Office of the Rail Regulator abolished.