

# Memorandum of Understanding between the Department for Transport and Network Rail

## Scope and purpose

1. The Office for National Statistics (ONS) announced today (17<sup>th</sup> December 2013) that it plans to reclassify Network Rail Limited and its subsidiaries (together referred to as Network Rail) to the public sector from 1<sup>st</sup> September 2014 when new EU reporting rules come into force. The effect of this reclassification will be to bring the company's debt and any future borrowings onto the public sector balance sheet.
2. This Memorandum of Understanding sets out the implications of this statistical reclassification for the relationship between Network Rail and Her Majesty's Government. It also explains where further work will be needed to determine the way this relationship will function. We intend to set out the conclusions of that work in a Framework Agreement between the Department for Transport and Network Rail.
3. The Framework Agreement will aim to preserve Network Rail's ability to continue managing its business with appropriate commercial freedom, within a proper regulatory and control framework to maintain effective accountability.

## Geographical coverage

4. Network Rail's activities span England, Wales and Scotland. This Memorandum of Understanding is between Network Rail and the UK Department for Transport, which has responsibility for the railways in England and Wales, as well as some reserved railway matters in Scotland such as safety, standards and cross-border services.
5. In Scotland, passenger rail services and infrastructure investment are a devolved matter for the Scottish Government. In leading on the development of a Framework Agreement, the Department and Network Rail will engage the Scottish Government to take account of its views.

## Impact of the change in classification on the railway

6. The change in Network Rail's classification by ONS is a statistical decision. It will not affect the Government's commitment to the railways or its plans for investment, including both its existing rail investment strategy for 2014-19 and HS2.

7. Nor will it alter the Government's plans to seek continued private sector investment in rail through franchising, the programme for which will remain unaffected from that published in March 2013.<sup>1</sup> The change will have no effect on passengers – fares, punctuality and timetables will be unaltered. The Office of Rail Regulation will continue as the economic, competition and safety regulator for the railway.
8. The Government's general approach to this reclassification is therefore only to make changes where they are: required to satisfy Government and Parliamentary budgeting and accountability requirements; or justified to deliver value for money. Where such changes are required, Government will work constructively with Network Rail in light of the ONS decision to reclassify in a way that balances commercial efficiency and accountability in the public sector.

## Background and general approach

### Background

9. Network Rail is a not-for-dividend company limited by guarantee set up under Companies Act legislation. The company has a Board of executive and non-executive directors. It is overseen by a panel of 43 Members, who act in place of shareholders in holding the Board to account.
10. Network Rail is regulated by the independent Office of Rail Regulation (ORR). The ORR carries out safety, economic and competition regulation for the rail industry. It is responsible for determining the outputs that NR must deliver over a five-year regulatory period, and the income that it needs to do this, including targets for efficiency and performance against which the ORR holds the company accountable.
11. The ONS has previously classified Network Rail as a private sector organisation assessed against Eurostat's ESA95 reporting rules.<sup>2</sup>
12. Today (17 December 2013) the ONS declared its intention to reclassify Network Rail to the public sector for statistical purposes when Eurostat's new ESA 10 reporting rules come into force on 1<sup>st</sup> September 2014.<sup>3</sup>

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<sup>1</sup> Department for Transport, *Rail franchise schedule* – March 2013

<https://www.gov.uk/government/publications/rail-franchise-schedule>

<sup>2</sup> During the initial stages of Network Rail's existence, following its establishment in October 2002, Government control over the company led the ONS to classify it to the public sector for a short period. However, Network Rail has been classified to the private sector since 2003.

<sup>3</sup> Eurostat – *European System of Accounts 2010* (ESA10) -

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:174:0001:0727:EN:PDF>

13. The ONS' decision to reclassify Network Rail for statistical purposes arises only out of the new Eurostat reporting rules. It is not due to any other change in the circumstances or performance of Network Rail.

#### The railway's record since Network Rail's establishment in 2002

14. Over the last decade, there has been significant growth in the volume of passengers and freight using the rail network. Over the same period, Network Rail has reversed the decline in the condition of the railway asset, bringing significant improvements in safety and performance. This has been done in partnership with train operators and the supply chain, within the policy and regulatory framework provided by Government and the ORR.

#### General approach to the relationship between Network Rail and Government

15. Notwithstanding the statistical changes to its status, the principle guiding this Memorandum of Understanding is the preservation of Network Rail's ability to continue to manage its business with appropriate commercial freedom within effective regulatory and control frameworks for a company in the public sector.
16. The Government's general approach to this reclassification is therefore only to make changes where they are required: to satisfy Government and Parliamentary budgeting and accountability requirements; or justified to deliver value for money. Where such changes are required, Government will work constructively with Network Rail to allow Network Rail to continue to build on the successes described above.

#### Accounting, budgeting and assurance framework

17. Following Network Rail's reclassification to the public sector for statistical purposes, when Eurostat's new reporting rules come into force on 1<sup>st</sup> September 2014, the company will need to be accountable for its activities and its finances to Parliament.
18. In putting in place an accounting, budgeting and assurance framework for the company, Government and Network Rail will need to ensure that the arrangements are not likely to restrict the company's operational decision-making in a way that would be detrimental to achieving value for money.
19. For this reason, the company's financial and performance framework will be structured to hold Network Rail accountable for delivering against the output

targets set by ORR's five-year regulatory settlement for 2014-19,<sup>4</sup> and to give it the appropriate commercial flexibility it needs to do so. This framework will also need to satisfy the requirements of the parliamentary accounting and budgeting process, which include for instance the appointment of an Accounting Officer in the company and the application of *Managing Public Money*, subject to any particular modifications that may be agreed.

20. The Framework Agreement between Network Rail and the Department for Transport will set out the detail of how the Department for Transport's Accounting Officer will gain assurance over the regularity and propriety, the affordability and sustainability and the value for money of Network Rail's activities. In doing so, we will seek to draw as much as we can from the existing control frameworks, in particular the duties and powers of the ORR as independent regulator. Network Rail and the Government will work together over the coming months to ensure any new requirements are met, working with the ORR and the National Audit Office (NAO).
21. Future audit arrangements, including the role of the Comptroller and Auditor General and the NAO, will need to be decided as the Framework Agreement is developed.
22. The ORR will continue to act as the independent economic, competition and safety regulator for Network Rail's activities, in accordance with the requirements of EU and UK law. The ORR's five-year determination, which involves the Department for Transport setting the budget and outputs for the relevant period, and the ORR's ongoing monitoring of Network Rail's delivery and expenditure, will help promote assurance over the value for money of NR's spending.

#### Existing debt and new borrowing

23. Network Rail raises debt on the financial markets for the purposes of financing its investment in the rail network. Its debt currently stands at circa £30 billion<sup>5</sup> and it plans to borrow approximately £16.5 billion to finance its activities over 2014-19. Network Rail will need to refinance approximately £11.5 billion of its existing debt over this period.
24. The vast majority of Network Rail's financing requirements is raised by issuing medium-long term multi-currency bonds through NR's special purpose financing vehicle: Network Rail Infrastructure Finance plc (NRIF). The

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<sup>4</sup> Office of Rail Regulation, October 2013 – *Britain's railways between 2014 and 2019 – ORR's final determination*

<http://www.rail-reg.gov.uk/server/show/ConWebDoc.11287>

<sup>5</sup> Network Rail, November 2013 - *Interim results* -

<http://www.networkrail.co.uk/browse%20documents/interim%20results/2013-14%20network%20rail%20infrastructure%20finance%20plc%20interim%20financial%20statements.pdf>

proceeds of NRIF's debt are advanced under an inter-company loan to Network Rail Infrastructure Limited, to fund the operations of Network Rail.

25. All debt that NRIF has issued is directly and explicitly backed by a guarantee from the Secretary of State for Transport - the Financial Indemnity Mechanism (FIM). The FIM means that in the event of NRIF not meeting its financial obligations, the UK Government would meet these obligations unconditionally. The FIM has allowed Network Rail to borrow at a lower interest rate than would otherwise be possible for a private sector company, helping to secure value for taxpayers' money. The ONS' decision to reclassify Network Rail to the public sector is a statistical decision which has no impact on the nature of any existing debt (which remains in the name of NRIF) or the provision of the FIM.
26. It is in the interest of both Government and Network Rail that the company continues to undertake its financing in the most efficient way possible. The company's financing decisions will continue to be driven by value for money for taxpayers, with appropriate consideration given to the fiduciary duties of Network Rail's directors and the long-term policy objectives for the railway.
27. The Government, the ORR and Network Rail will explore whether alternative approaches or refinements to the current model could deliver a more efficient approach, and if so from what point of time these might be introduced and how the benefit of any such efficiencies would be secured for funders. Until then, Network Rail will continue to raise finance with support of the FIM.

## Corporate Governance

28. Network Rail's primary corporate governance arrangements are set out in its Articles of Association ("the Articles"), its Membership Policy and its Incentive Policy. The Department for Transport is currently one of 43 Members of Network Rail who hold the Board to account.
29. Under the Articles, the Department for Transport has an existing right to appoint a non-executive Special Director to the company's Board. That Special Director would sit on the Nominations and Remuneration Committees, although would be in a minority on both. The Special Director would have the right to report information back to the Secretary of State but would also be bound by fiduciary duties to the company.
30. Reclassification of Network Rail is a statistical decision by ONS. It does not affect Network Rail's status as a company limited by guarantee. Nor are there automatic changes to corporate governance, the Board Directors or the Membership. However, from the point of reclassification on 1<sup>st</sup> September

2014, the Secretary of State gains certain additional rights as set out in the Articles and elsewhere.

31. The Secretary of State is considering whether to appoint a Special Director to Network Rail's Board to promote an open and transparent working relationship with Government.
32. Network Rail, Government and the ORR will consider what further changes in corporate governance may be required from 1<sup>st</sup> September 2014 as a consequence of the ONS' statistical decision to classify the company to the public sector. This work will consider whether it will be appropriate to change the framework for executive director pay and incentives or the role of the Members in light of Government's new accountability to Parliament for Network Rail. The work will build on Network Rail's own review, already underway, into the effectiveness of its corporate governance arrangements.