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Dear Alexandra

Network Rail's Response to ORR's PR13 Volume Incentive Consultation

This letter sets out Network Rail's response to ORR's *'Periodic Review 2013 – Volume Incentive consultation'*, published on 18 December 2012. We welcome the consultation and the opportunity to comment.

Background

Network Rail considers that the Volume Incentive can play a vital part in encouraging our staff to seek to accommodate additional trains onto the network. Absent such a mechanism Network Rail would be 'financially neutral' as to the level of trains that operate on the GB network. This is because the charges that we are permitted to levy on train operators are intended to be purely cost reflective. This means that each train that runs on the network is charged the incremental costs that it causes Network Rail in terms of us operating, maintaining and renewing our infrastructure. In many cases, the charges inevitably will not even cover the full cost of running additional trains because this depends on the precise circumstances which can never be captured in charges. The Volume Incentive addresses this issue in providing a financial reward for accommodating additional trains on the network, over and above the ORR determined baseline.

The industry has an agreed aim to make optimum use of the GB rail infrastructure so as to generate maximum value for the country. Indeed, this is implied by Network Rail's stated purpose of "generating outstanding value for taxpayers and customers". Consistent with this, the Volume Incentive creates a financial gain for the company to increase utilisation of the network. It can provide an important balance for the high-profile incentive to improve performance.

ORR's Questions and Other Key Issues

ORR's consultation sets out a number of proposals around the design of the Volume Incentive for CP5 and also includes a number of detailed questions. We respond to each of ORR's specific consultation questions in Annex A.

We welcome ORR's encouragement for Network Rail itself to propose an approach for the Volume Incentive in CP5. In response to that challenge, the key points we would make are set out below:

- We strongly support the Volume Incentive continuing to be set at a national level;

- We recognise the importance of being clear how a national incentive translates into each of the Operating Routes. We consider that Network Rail, in consultation with our train operating customers, is best placed to disaggregate a national incentive into route baselines for CP5;

- We recognise ORR's arguments in considering introducing a downside component for the Volume Incentive in CP5;

- Because the Volume Incentive is a mechanism that 'sits on top' of the cost reflective charging regime it will be unlikely that there will be any significant cost savings from traffic levels being below the baseline level for CP5, above those built into the cost reflective charging regime. Because of this we consider that, to help manage the financial risk on Network Rail of traffic figures being significantly below the national baseline in CP5, we consider that any downside component of the Volume Incentive should (similar to the new REBS mechanism) be capped at a national level. In our route-based allocations, however, we propose, that for simplicity, reporting route performance before taking account of any national cap;

- Assuming that the CP5 design of the mechanism reflects our suggestion of making the downside capped, we support strengthening the incentive by increasing the incentive rates. For simplicity, the rates should be the same above and below the baseline;

- We propose that any money resulting from outperformance of Volume Incentive traffic volumes should be calculated at a national level in regulatory terms. Network Rail would, transparently, apportion Volume Incentive figures between routes for reporting purposes. The Volume Incentive amounts would be included in any assessment of route performance including regulatory accounts and route-based bonus arrangements, including the Management Incentive Plan. Volume Incentive amounts would also be included in any assessment of outperformance or underperformance at an England & Wales and Scotland level;

- We propose that, where there is overall outperformance, decisions about how to use any gains would be made centrally in the light of the financial position of the company and other relevant circumstances. This is essential since there are likely to be areas where the business underperforms and others where we outperform targets. Any decision about how to use outperformance would, therefore, be made at an overall level rather than differentiating the source of outperformance; and

- We consider it is important that we are clear on the governance arrangements for use of outperformance. We are proposing that routes would be expected to make proposals as at present about ways of spending such sums. We propose working with passenger and freight operators through existing processes consistent with the use of other CP5 funds in determining which schemes to fund. We would be transparent about how we spend any outperformance and report this in our regulatory accounts with further detail in the annual return as appropriate.

Summary

The Volume Incentive plays a very important contribution toward making maximum use of the GB railways. Without it Network Rail would get no direct financial reward for growing traffic. We do not consider that the existence of the Volume Incentive reduces our output commitments to operators and other funders but it does incentivise the promotion or facilitation of incremental growth. Following devolution, there is greater focus on route P&Ls, rather than just costs, so it is natural for us to include the Volume Incentive in route financial performance measures and to consider it part of how we measure success at a route level.

Overtime, we believe that there could be merit in considering other ways of creating financial reward for accommodating additional traffic on the network. However, as highlighted in our response to ORR's first PR13 consultation in September 2011, we see merit in making only minor changes where necessary to the structure of charges in CP5. As you will know, we are fully committed to the accelerated review of incentives and charges during CP5 for CP6, sponsored by the Rail Delivery Group. It could be that possible alternatives to the Volume Incentive could form part of that work.

Please feel free to contact my colleague Mike Roberts (Mike.Roberts@networkrail.co.uk) should you wish to discuss any aspect of this response in more detail.

Yours sincerely

Peter Swattridge

Head of Regulatory Economics

Annex A - Responses to consultation questions

Q.1.Do you recognise the importance of efficient management of network capacity in driving improvements in value for money from the rail network? Do you recognise the role played by the Volume Incentive, if effective, in driving behaviours which contribute to more efficient capacity management? Is there more that we could be doing, through the Volume Incentive or otherwise, to improve the development of information which would help to improve efficient capacity management and to inform the system operator?

Do you recognise the importance of efficient management of network capacity in driving improvements in value for money from the rail network?

We are fully committed to minimising the degree to which government needs to subsidise the GB railway and consider that the efficient management of network capacity is important to achieving this. We strive to improve 'value for money' over the entire rail network. We consider network capacity to be a scarce resource in some parts of the network and we fully support initiatives to incentivise best use of existing capacity, and continue to welcome the principle of the Volume Incentive as an effective way to contribute to this objective. Equally, on those parts of the network where there is capacity, the Volume Incentive has an important role to play in incentivising the introduction of new services.

Do you recognise the role played by the Volume Incentive, if effective, in driving behaviours which contribute to more efficient capacity management?

Network Rail considers that the Volume Incentive can play a vital part in encouraging our staff to seek to accommodate additional trains onto the network. Absent such a mechanism, Network Rail would be held 'financially neutral' to the level of trains that operate on the GB network. This is because the charges that we are permitted to levy on train operators are intended to be purely cost reflective. This means that each train that runs on the network is charged the incremental costs that it causes Network Rail in terms of us operating, maintaining and renewing our infrastructure. In many cases the charges inevitably will not even cover the full cost of running additional trains because this depends on the precise circumstances which can never be captured in charges. The Volume Incentive addresses this issue in providing a financial reward to Network Rail for accommodating additional trains on the network, over and above the ORR determined traffic growth baseline.

The industry has an agreed aim to make optimum use of the GB rail infrastructure so as to generate maximum value for the country. Indeed, this is implied by Network Rail's purpose[1] of "generating outstanding value for taxpayers and customers". Consistent with this, the Volume Incentive creates a financial gain for the company to increase utilisation of the network. It can provide an important balance for the high profile incentive to improve performance.

[1] Network Rail's purpose, role and vision

<u>Is there more that we could be doing, through the Volume Incentive or otherwise, to improve the development of information which would help to improve efficient capacity management and to inform the system operator?</u>

We consider that Network Rail devolution and new working arrangements with customers, for example through alliances, should allow us to work together and identify opportunities, including relating to accommodating additional capacity. We consider that these new ways of working should continue to be encouraged.

As part of our transparency agenda[2] we are committed to becoming more open with our information with the aim of stimulating debate on our work and that of the rail industry. We are continually making more information available to the public.

Accordingly, we consider that, in light of our transparency agenda, ORR does not need to do anything more at this stage in the development of information; but rather, has a role to play in making sure that the incentive framework is robust and fit for purpose and does not inhibit new ways of working and alliances as discussed above.

[2] http://www.networkrail.co.uk/transparency/

Q.2. Do you recognise the important potential role of charges in providing information on costs and the uses of revenues and subsidy and in sending better signals for efficient provision and use of network capacity? Do you have any comments on the proposed scope, and timing, of the longer-term work programme to develop charges as outlined above?

Do you recognise the important potential role of charges in providing information on costs and the uses of revenues and subsidy and in sending better signals for efficient provision and use of network capacity?

As highlighted in our response to ORR's first PR13 consultation in September 2011[3], we believe that before considering the effectiveness of current charges and possible future charges, it is important to consider what the industry is trying to achieve and the enablers in place to achieve the objectives. The charging regime can then be assessed, alongside the incentive framework, as to how it supports these enablers.

We consider that there could be three main aims for charging:

- Cost recovery;
- Signals to decision makers; and / or
- Supporting competition / contestability.

It is expected that 'trade-offs' between these aims may need to be made. This would require an understanding of how the charging regime fits in with the wider regulatory and contractual framework. Currently, the focus for charging is cost recovery. Careful consideration would need to be given if this balance was to shift primarily. We would suggest that there is clear articulation of any problems with the existing regime, which a new regime seeks to 'correct', and the outcomes that any changes are intended to support.

Do you have any comments on the proposed scope, and timing, of the longer-term work programme to develop charges as outlined above?

As highlighted in our response to ORR's first PR13 consultation in September 2011, we see merit in making only minor changes where necessary to the structure of charges in CP5. As the industry is aware, we are fully committed to the accelerated review of incentives and charges during CP5 for CP6, sponsored by the Rail Delivery Group (RDG) and are, therefore, supportive of ORR's proposal to use the RDG Contractual and Regulatory Reform sub-group as a forum in which to discuss the long-term programme of works.

As stated above, we consider that it is important to be clear on the outcomes that any changes in the charging framework are intended to support so that charges and incentives are appropriately focussed and designed.

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[3] http://www.networkrail.co.uk/uploadedFiles/networkrailcouk/Contents/Publications/Delivery_Plans/Control_Period_5_delivery_plan/Planning_for_CP5/ORRFirstPR13ConsultationFull.pdf

We consider that an important objective of the review should be to support and encourage new ways of working between ourselves and our customers, avoiding the introduction of further complexity. We consider that it could be that possible alternatives to the Volume Incentive could form part of that work.

Q.3. Do you have any specific experiences of the effectiveness of the current Volume Incentive which it would be helpful to share? Can you provide specific examples of where the incentive does appear to have worked and where it has not? Why exactly do you think that the incentive is not fully effective at present?

Do you have any specific experiences of the effectiveness of the current Volume Incentive which it would be helpful to share?

We consider that the Volume Incentive has been an effective means by which to incentivise Network Rail to accommodate additional traffic on the network above our regulatory targets. In the first 3 years of CP4, we earned £75m from the Volume Incentive. This was due to growth in passenger train miles, against a baseline rate of growth of 0.8% p.a., shown in the table below.

Passenger Train Miles	**Baseline** (million miles)	**Actuals** (million miles)	**Actual growth** (% per annum)
Base: 2008/09	282.66	282.66	-
2009/10	284.92	294.70	4.26%
2010/11	287.20	300.13	1.84%
2011/12	289.50	307.76	2.54%

In CP3 we created an outperformance fund for investment in the network and in CP4 we have also made discretionary investment as a result of projected outperformance. We have always considered that the ability to reinvest outperformance is an important motivational tool for the business.

Can you provide specific examples of where the incentive does appear to have worked and where it has not?

The above table indicates that we have been responsive to requests for additional capacity for passenger services. We have outperformed our baseline, and have earned £75m for the first 3 years of CP4, for the passenger aspect of the Volume Incentive. However, it is possible that had the Volume Incentive been stronger, through increased payment rates, then growth might have been larger.

For the first 3 years of CP4 we have not achieved the Volume Incentive baselines for freight, in either aspect of the metric, as shown in the tables below. We consider that this has been largely due to exogenous factors which have affected the freight market, for example the recession, and not due to a lack of incentive for Network Rail to accommodate additional traffic above our regulatory targets. Due to the design of the Volume Incentive in CP4, having no downside, we have not been impacted financially by this.

Freight Train Miles	Baseline	Actuals	Actual Growth
	(million miles)	(million miles)	(% p.a.)
Base: 2008/09	27.19	27.19	-
2009/10	27.82	24.59	-9.56%
2010/11	28.46	24.09	-2.01%
2011/12	29.11	25.39	5.39%

Freight Gross Tonne Miles	Baseline	Actuals	Actual Growth
	(in millions)	(in millions)	(% p.a.)
Base: 2008/09	28,438	28,438	
2009/10	28,893	24,036	-15.5%
2010/11	29,355	26,062	8.4%
2011/12	29,825	28,284	8.5%

Why exactly do you think that the incentive is not fully effective at present?

We consider that, consistent with Network Rail devolution, there is now an opportunity to disaggregate the reporting of the Volume Incentive to make the route-based contribution to national growth more explicit. We consider that this could increase the effectiveness of the Volume Incentive by disaggregating the traffic growth forecasts to the level that decisions are made, i.e. by operating route.

In translating a national incentive target to our Operating routes we recognise the importance of being clear and transparent. We consider that Network Rail, in consultation with our train operating customers, is best placed to disaggregate a national incentive into route-based baselines for CP5. This is discussed in further detail in our response to **Q6**

In CP4, payments from the Volume Incentive are not recognised through our annual FVA measure. We consider that, in CP5, there would be merit in the inclusion of the Volume Incentive in our annual FVA measure, as we did in CP3. This is a measure by which we report financial performance and we consider that the inclusion of the Volume Incentive in FVA creates a link to route performance and increase the visibility of the incentive to decision makers. Unlike CP3, we would consider this on a route basis.

We will be looking to Network Rail to set out how the Volume Incentive is likely to affect its decision making process in the future

In principle, we agree that disaggregating the incentive to route level is a sensible and practical refinement to the mechanism for CP5, since route-based baselines are consistent with our devolved organisational structure. We also consider that, in doing so, the Volume Incentive is moved closer to decision makers who have the ability to influence behaviours and outcomes at a local level. In addition to this, as stated above, we consider the inclusion of the Volume Incentive in our annual FVA measure would create a link to route performance and increase the visibility of the incentive to decision makers ‘on the ground’.

Q.4. Do you agree with the range of design features which we have chosen to consider with the aim of improving the effectiveness of the incentive? Are there other changes you think we should consider making? If so, how would these changes improve the effectiveness of the incentive? Do you think that possible changes to the design and levels of the Volume Incentive have the potential to improve its effectiveness?

Do you agree with the range of design features which we have chosen to consider with the aim of improving the effectiveness of the incentive?

We welcome ORR's consultation and the opportunity afforded us to propose an approach for the Volume Incentive in CP5. We support the aim of improving the effectiveness of the Volume Incentive and consider that there are a number of ways in which this could be achieved, which we discuss below.

We are supportive of the proposed options to improve the Volume Incentive considered in the consultation. We consider that ORR increasing the Volume Incentive payment rates and Network Rail disaggregating the Volume Incentive by route should contribute towards the aim of improving the effectiveness of the Volume Incentive.

We initially, as stated in our response to ORR's first PR13 consultation in September 2011, queried the merits of being exposed to a downside to the Volume Incentive as we consider the threat of licence breach acts as an incentive in itself for us to meet the HLOS requirements, including traffic targets, and that this incentive is relatively powerful. On further consideration, however, we are not averse to the introduction of a downside to the Volume Incentive. We discuss our proposal for the design of a downside mechanism in the detail in response to **Q8**.

Are there other changes you think we should consider making? If so, how would these changes improve the effectiveness of the incentive?

In our response to ORR's first PR13 consultation in September 2011 we highlighted a number of ways in which to improve the effectiveness of the Volume Incentive by:

- **increasing** the incentive payment rates – to the size of the overall incentive;
- making payments to Network Rail **within** the control period – to increase the visibility of Volume Incentive;
- **disaggregating** the Volume Incentive by route – to move the Volume Incentive closer to route decision makers;
- combining the Volume Incentive with the **Capacity Charge** – to clarify the risk implications on performance of accommodating additional traffic; and
- considering in the context of **potential cost and revenue sharing arrangements** with train operators more commercial arrangements with our customers around capacity.

In addition to the above, overtime, we suggest that there could be merit in considering other ways of creating financial reward for accommodating additional traffic on the network. As stated earlier, we, however, see merit in making only minor changes to the structure of charges in CP5 and suggest that the other design options, not considered in this consultation, could be investigated further as part of the RDG Contractual and Regulatory Reform sub-group accelerated review of incentives and charges during CP5 for CP6, which is discussed earlier in our response.

Do you think that possible changes to the design and levels of the Volume Incentive have the potential to improve its effectiveness?

We agree with the range of design features ORR has chosen to review. We are also supportive of the proposal to increase the incentive payment rates and to disaggregate the Volume Incentive.

We consider that if the payment rates are higher, then the incentive would be stronger. We provide further views on this area of the design in our response to **Q14** and **Q15**

We consider that the disaggregation of the Volume Incentive to Operating Route level could help increase the understanding of the Volume Incentive to decision makers in our devolved organisational structure. We provide further views on this area of the design in our response to **Q7**.

Q.5. Do you have views on what would be involved in calculating the actual incentive rates at a route level to a sufficient degree of robustness? Are alternative approaches to calculating route level incentives available? Are route level incentive rates likely to increase the complexity of the incentive beyond their benefits?

Do you have views on what would be involved in calculating the actual incentive rates at a route level to a sufficient degree of robustness?

ORR's consultation considered three options for calculating the Volume Incentive at a route level:

- *Option 1: Calculating the total incentive payment at a national level with a simple apportionment of the total to each route according to a measure of the route relative size;*

- *Option 2: Applying a national incentive rate to the increase in volume achieved on each route; and*

- *Option 3: Calculating incentive rates to reflect the value of an increase in volume for each route and applying the individual route incentive rate to the volume increased achieved by the route.*

We are supportive of ORR's proposal to continue to calculate an incentive rate for the Volume Incentive at a national level - Option 2 in the consultation:

We do not consider there to be a worthwhile benefit to disaggregating incentive rates by route, Option 3. Furthermore it is not clear what disaggregation metric would be used.

In considering this issue, it is worth bearing in mind the intended purpose of the Volume Incentive is to incentivise Network Rail to accommodate traffic demand above the regulatory targets. We consider that disaggregating the Volume Incentive rates to route level would only be appropriate if the purpose of the Volume Incentive is moved more towards targeting growth in specific routes as opposed to others.

Are alternative approaches to calculating route level incentives available?

As stated above, we do not consider there to be a worthwhile benefit to disaggregating incentive rates by route.

However, we consider that the disaggregation of a nationally set traffic growth baseline to route level targets would provide an alternative to calculating the incentive rates at a route level. This would create a link between route performance and Volume Incentive payments. We consider that this would contribute towards improving the visibility of the Volume Incentive and would provide a link from decisions made to payments received.

Are route level incentive rates likely to increase the complexity of the incentive beyond their benefits?

As discussed above, we consider that calculating the actual incentive rates at a route level would increase the level of complexity of the Volume Incentive and the administrative burden in calculating it. We consider that the negative effect this may have could outweigh the benefits. If the purpose of the Volume Incentive is to continue to be to incentivise Network Rail to accommodate additional traffic on the network as a whole, then we suggest there is merit in keeping the calculation of the incentive rate at a national level.

As stated above, we consider that an alternative approach would be to disaggregate the traffic growth baselines to route level.

Applying any caps on the Volume Incentive upside or downside would increase complexity and / or create distortions. As a result, we propose that the Volume Incentive and any caps should be calculated nationally. Network Rail would then calculate the route-based element and report this locally before the application of any caps.

Q.6. Do you agree that disaggregating the incentive to an operating route level by measuring actual volume relative to route based baselines is the most sensible and practical refinement to the existing Volume Incentive and that it could improve its effectiveness? What alternative approaches might exist which facilitate the calculation of route level incentive rates – and would these be sufficiently representative to drive differing behaviour according to value?

Baselines

In its consultation, ORR proposes that growth baselines for CP5 will be set in a similar way to the CP4 mechanism. In CP4 the growth baselines were set using forecasts underpinning the SBP and HLOS. This baseline for growth was then apportioned equally across the 5 years of CP4.

We consider that there could be merit in adjusting this approach for CP5 to take into account the following arguments:

- We consider that the freight traffic forecasts in the SBP are ambitious, particularly the coal traffic component. They are based on forecasts of growth from the strategic freight network and their delivery is reliant on a number of external parties e.g. development of ports and freight terminals. We will be revisiting our forecasts in order to inform the Final Determination and Delivery Plan, to reflect the latest views of enhancement schemes and Department of Energy and Climate Change's (DECC) more up to date view of the use coal. We consider that there would be merit in using these forecasts, when available, as the baseline for the Volume Incentive for CP5;

- Traffic growth in CP5 is expected to be concentrated more towards the end of the control period when a number of traffic growth enabling enhancements (Thameslink, Crossrail) will be completed. If the CP5 Volume Incentive baseline were to be apportioned equally across the control period, as it is in CP4, then the baseline would be likely to be unachievable for much of CP5.

As stated above, we consider that the traffic growth baseline for the Volume Incentive in CP5 should be based on traffic growth forecasts used in our Delivery Plan and should not be apportioned equally across the control period; reflecting the fact that growth over CP5 is forecast to be in the later years of the control period.

Do you agree that disaggregating the incentive to an operating route level by measuring actual volume relative to route based baselines is the most sensible and practical refinement to the existing Volume Incentive and that it could improve its effectiveness?

As stated earlier, in principle, we agree that disaggregating the incentive to route level is a sensible and practical refinement to the mechanism for CP5, since route-based baselines are consistent with our devolved organisational structure. We also consider that, in doing so, the Volume Incentive is moved closer to decision makers who have the ability to influence behaviours and outcomes at a local level.

As stated in our response ORR's December 2011 Periodic Review 2013 consultation on incentives[4], we consider that disaggregation may not be straightforward in practice. We strongly believe that, due to our intimate knowledge of the railway at a local level, we are best placed, in consultation with our passenger and freight customers, to determine how a national incentive target should be disaggregated.

Furthermore, we believe that Network Rail should define the most efficient use of any monies gained from the Volume Incentive across Network Rail. We consider that it would be inappropriate to hypothecate any gains (or loses) at route level. This would be inconsistent with our management of the Network as a portfolio of routes. It would also import extra cost to the network on aggregate, due to the loss of portfolio management benefits.

What alternative approaches might exist which facilitate the calculation of route level incentive rates – and would these be sufficiently representative to drive differing behaviour according to value?

We consider that, consistent with CP4, a nationally set traffic growth baseline should continue for CP5. We consider that this is reflective of the purpose of the Volume Incentive as a network wide incentive for Network Rail to accommodate additional traffic above its regulatory targets.

As discussed above, we strongly believe that we are best placed, in consultation with our customers, to disaggregate a nationally set ORR traffic growth target into Operating Route baselines due to our intimate knowledge of the railway at a local level. We consider that this could be set in a transparent manner consistent with the overall national target.

We propose to do this by disaggregating our traffic growth forecasts, based on assumptions used for our Delivery Plan, by route and reporting route performance against these baselines.

We consider that setting the baseline by apportioning growth equally across the control period would be likely to have the effect of making the baseline unachievable for the first 3-4 years of CP5. As discussed, In CP5, growth is not forecast to be uniform across the control period. It is forecast to be concentrated towards the latter years when a number of enhancements (Thameslink, Crossrail) will be completed and economic growth is forecast to occur.

We also consider there would be merit in fixing national targets at the start of the control period based on Network Rail national traffic growth forecasts used for our Delivery Plan. Separately, we consider it important that Network Rail is able to adjust incentives as it sees fit for staff bonus arrangements in each route.

[4] http://www.networkrail.co.uk/WorkArea/DownloadAsset.aspx?id=30064780543

Q.7. Do you think that alternative ways of disaggregating the incentive for example by Train Operating Company are attractive? What do you think what be the impact of this on the incentive properties of the Volume Incentive? How would freight and open access operators be affected by TOC (or indeed) route level disaggregation given that they often span multiple routes but not in the same way as TOCs?

Do you think that alternative ways of disaggregating the incentive for example by Train Operating Company are attractive?

As previously stated, we are supportive of the proposal to continue with a national incentive rate for CP5 (option 2 in the consultation). Since the intention is to incentivise growth regardless of who is operating the service, we consider it appropriate that the Volume Incentive is not disaggregated by Train Operating Company. We also recognise that this would increase the complexities associated with the calculation of the Volume Incentive and consider that there may sensitivities from TOCS around sharing fare-box revenue figures.

What do you think what be the impact of this on the incentive properties of the Volume Incentive?

We consider that if incentive rates were set at different levels for different TOCs, this may result in incentives for Network Rail to accommodate additional traffic from one TOC as opposed to another, which may not be acceptable.

How would freight and open access operators be affected by TOC (or indeed) route level disaggregation given that they often span multiple routes but not in the same way as TOCs?

We consider that setting the Volume Incentive at TOC level could have an adverse effect on new entrants in freight and open access markets. New entrants would not have a Volume Incentive baseline set for the growth in their traffic and would therefore not be contributing to a Volume Incentive traffic growth baseline. As a consequence of this, Network Rail would not be as strongly incentivised to accommodate requests for traffic from these new entrants as we would not receive a Volume Incentive payment and therefore would only recover our marginal costs.

Q.8. Do you agree that, in principle, a downside could improve Network Rail's responsiveness to unexpected demand for the use of network capacity and improve its overall incentives, and ability, to improve efficiency in capacity management? Do you have views on the possible design of the downside mechanism?

Do you agree that, in principle, a downside could improve Network Rail's responsiveness to unexpected demand for the use of network capacity and improve its overall incentives, and ability, to improve efficiency in capacity management?

We initially queried the merits of being exposed to a downside to the Volume Incentive as we consider the threat of licence breach acts as an incentive in itself for us to meet the HLOS requirements, including traffic targets, and that this incentive is relatively powerful. On further consideration, however, we are not opposed in principle to the introduction of a downside to the Volume Incentive.

However, ORR should recognise that we will not save significant costs if fewer trains run as the current charging regime, being cost reflective, holds the company 'financially neutral' as to the level of trains that operate on the GB network. This means that each train that runs on the network is charged the incremental costs that it causes Network Rail in terms of us operating, maintaining and renewing our infrastructure.

The Volume Incentive addresses this issue in providing a financial reward for accommodating additional trains on the network, over and above the ORR determined baseline.

As stated before, we also consider that the threat of licence breach acts as an incentive in itself for us to meet the HLOS requirements, including traffic targets, and that this incentive is relatively powerful. We therefore, query whether the introduction of a downside to the Volume Incentive would be necessary as there are powerful incentives already placed on Network Rail to respond to unexpected demand for the use of network capacity, and ensure that we make best endeavours to meet our regulatory targets. On balance we would, however, be content to see the introduction of a downside to the regime, as long as it was accompanied by a cap. However, any financial impact from introducing a downside component to the Volume Incentive should be factored into the size of Network Rail's risk buffer[5] as part of PR13.

Do you have views on the possible design of the downside mechanism?

We consider that the introduction of a downside could expose us to financial risk for non-delivery of growth from exogenous factors, especially with regard to freight where traffic growth is related to wider economic conditions and infrastructure development, for example development of a port. Therefore, we consider that some form of cap on our exposure to downside seems appropriate to reflect this risk. We consider there is merit in the design of the downside to be symmetric (i.e. upside and downside rates being equal) with a downside cap.

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[5] One way of doing this for CP5 would be to increase the debt to RAB limit that is set out in our licence.

A cap would also be consistent to the new route-based Efficiency Share mechanism on which ORR made its conclusions in December 2012. For simplicity, however, we believe it is important that any caps are applied nationally rather than at route level. The Volume Incentive should, therefore, be applied nationally by ORR. Network Rail would report performance of the route-based components at a local level before the application of any caps.

Q.9. Do you agree that we should continue to apply the Volume Incentive to all routes regardless of whether it is a 'congested' route?

Do you agree that we should continue to apply the Volume Incentive to all routes regardless of whether it is a 'congested' route?

We support the proposal to continue to apply the Volume Incentive across the network irrespective of whether all of it is congested or not. We consider that applying the incentive to only congested routes may have a discriminatory effect on non-congested routes and remove the financial incentive for Network Rail to accommodate additional traffic on those parts of the network. As stated earlier, absent the Volume Incentive, Network Rail is financially neutral to additional traffic due to the structure of charges.

Of the issues identified in the consultation, we consider the following to be most important when considering whether to apply the Volume Incentive to only congested routes:

- It is unlikely that congestion would apply to a whole operating route and therefore there would be a requirement to disaggregate the incentive so that it only applied to congested sections of operating routes, this would appear to be very complex; and

- Network Rail is responsible for declaring sections of track as congested. If the Volume Incentive was applied to only congested routes, this could create a perverse incentive for Network Rail to declare parts of the network as being congested.

We consider that the increased complexity and potential administrative burden introduced by restricting the incentive to only certain parts of the network would be greater than the benefit derived. We support the proposal to apply the Volume Incentive to all routes regardless of whether they are congested or not.

Q.10. Do you agree that we should continue to exclude ESI coal and spent nuclear fuel freight from the Volume Incentive? Should this still be done if the incentive is calculated at the route level?

Do you agree that we should continue to exclude ESI coal and spent nuclear fuel freight from the Volume Incentive?

We are supportive of the proposals to continue to exclude ESI coal and spent nuclear fuel from the freight Volume Incentive calculations.

Should this still be done if the incentive is calculated at the route level?

We consider that the rationale for the exclusion of ESI coal and spent nuclear fuel freight is not dependant on what level the volume is calculated. We consider that regardless of the disaggregation of the Volume Incentive, ESI coal and spent nuclear fuel should be excluded from the Volume Incentive.

Q.11. Do you agree that we should continue to allow Network Rail to benefit from all growth regardless of how it has arisen?

Do you agree that we should continue to allow Network Rail to benefit from all growth regardless of how it has arisen?

We are supportive of proposals for us to continue to benefit from all growth regardless of how it has arisen (with the exception of ESI coal and spent nuclear fuel). We consider that if some volume growth that is not attributable to Network Rail's actions is excluded from the Volume Incentive, we would have less incentive to accommodate this additional traffic. This is because, as we have previously stated, Network Rail would be financially neutral to the additional traffic.

We consider that if the Volume Incentive is adjusted so that Network Rail only benefited from increased growth attributable to its actions, it would also have to take into account falls in growth resulting from exogenous factors. Overall, we consider that this would become far too complex.

Q.12. Do you agree that we should continue with the present payment mechanism but promote its annual accounting at route level? You are invited to put forward alternative or additional proposals to improve the understanding of, and engagement with, the incentive, both in relation to how it is paid and accounted for and any other governance features.

Do you agree that we should continue with the present payment mechanism but promote its annual accounting at route level?

We consider that payment should continue, as in CP4, to be at a single national level. We support the proposal for payments to Network Rail to continue to be paid through the Opex memorandum account and added to our revenue requirement in the subsequent control period (option b in the consultation).

As previously stated, we consider that use of any funds from any overall outperformance should be decided by Network Rail and not 'hypothecated' to an individual route. This is consistent with the company managing the routes as a 'portfolio' and pooling risk. Even within a route, areas of outperformance need to be considered in conjunction with areas of underperformance. For both these reasons it is inappropriate to consider use of the Volume Incentive in isolation from other aspects of performance and it is particularly inappropriate in doing so at a disaggregated level. Traffic performance could still be reported at a route level.

You are invited to put forward alternative or additional proposals to improve the understanding of, and engagement with, the incentive, both in relation to how it is paid and accounted for and any other governance features.

We consider that the inclusion of the Volume Incentive within Network Rail's FVA would increase the power of the Volume Incentive by creating a link to route performance and increasing the visibility of the incentive to decision makers. This was done in CP3 and we should revert to this approach.

Q.13. Do you agree that we continue to use broadly the existing approach to calculating incentive rates? What other approaches might be available and how would they improve the effectiveness of the Volume Incentive relative to the existing approach?

Do you agree that we continue to use broadly the existing approach to calculating incentive rates?

While the current incentive rates are based on what appears to be a robust methodology, it is obvious that if the rates were higher, the incentive for Network Rail to accommodate additional traffic would be stronger. If the overarching aim is to increase the power of the incentive, this appears to be the simplest approach.

What other approaches might be available and how would they improve the effectiveness of the Volume Incentive relative to the existing approach?

We would suggest a small refinement to the design of the freight metric (this is discussed in response to Question 15).

Q.14. Do you expect that the passenger incentive rates that we have proposed would drive significantly better capacity management on Network Rail's part? If not, please explain what level of rates would be needed to be effective in changing Network Rail's behaviour and why? We are interested in your view on an alternative higher rate proposal set out in Annex C.

<u>Do you expect that the passenger incentive rates that we have proposed would drive significantly better capacity management on Network Rail's part?</u>

We are supportive of the proposed increase in payment rates subject to the inclusion of a downside. We also, consider that , given the trade-off of performance against traffic growth, the Volume Incentive would be more effective if the payment rates were increased.

<u>If not, please explain what level of rates would be needed to be effective in changing Network Rail's behaviour and why?</u>

We consider that the increase in incentive rates should be considered in relation to any additional risk we may face through the performance regime, which may not be captured by the capacity charge. This is because the capacity charge is only recalibrated at periodic review using a 'snapshot' view of traffic and has not been recalibrated since 2000/01

<u>We are interested in your view on an alternative higher rate proposal set out in Annex C.</u>

We consider that the incentive rates in the Volume Incentive should be set at a level that will continue to incentivise Network Rail to accommodate traffic demand above the regulatory targets. We do, however suggest that, when considering increasing the incentive rates to the higher level, it would be important that ORR considers the relative size of the incentive in comparison with the incentives we already have to achieve our regulatory targets – e.g. performance targets.

Q.15. Do you expect that the freight incentive rates that we have proposed would drive significantly better capacity management on Network Rail's part? If not, please explain what level of rates would be needed to be effective in changing Network Rail's behaviour and why? Do you consider that freight rates should be adjusted on the grounds that a difference between passenger and freight rates has the potential for a distortionary incentive effect?

Do you expect that the freight incentive rates that we have proposed would drive significantly better capacity management on Network Rail's part? If not, please explain what level of rates would be needed to be effective in changing Network Rail's behaviour and why?

The CP4 Volume Incentive freight metric uses freight train miles and gross tonne miles (KGTM), however we suggest that for CP5 greater weight be given to the metric KGTM. This would reward Network Rail for more freight efficient traffic growth, as it would reflect the use of longer, or more laden, trains.

We consider that the freight incentive rate used in the Volume Incentive should reflect the value of diverting traffic from roads and onto rail. We consider that, of the two components of the freight metric, KGTM is more reflective of the value associated with moving freight traffic onto rail as it takes into account the increase in volume being transported, where as the freight train miles reflects costs.

The freight incentive rates in CP4, and proposed for CP5, shown below, place greater value on growth in train miles in comparison with KGTM. Also shown are the incentive rates for CP3, when the Volume Incentive was first introduced, where the KGTM incentive rate was higher.

Freight incentive rates	Pence per additional train mile	Pence per additional 000 tonne miles
Proposed for CP5	276p	235p
Current CP4 rates	111p	100p
CP3 rates (2002/03 prices)	64p	80p

We consider the effect of greater value being given to the freight train mile metric could create a perverse incentive, whereby Network Rail has a greater incentive to accommodate many short trains as opposed to longer, or more laden trains, despite the fact that the latter are a more efficient use of network capacity.

The CP4 freight metric uses freight train miles and KGTM. We suggest that freight metric for CP5 greater weight be given to the metric KGTM. This would reward us for more freight efficient traffic growth, as it would reflect longer fuller trains.

Do you consider that freight rates should be adjusted on the grounds that a difference between passenger and freight rates has the potential for a distortionary incentive effect?

We consider that freight rates should be increased in line with passenger rates. We consider that the Volume Incentive should incentivise Network Rail to accommodate requests for additional traffic, regardless of the type – freight or passenger. We consider that if greater value is placed on additional passenger traffic, as opposed to freight, this may create an incentive for Network Rail to unduly favour accommodating one traffic type over another.