Periodic review 2013

Aligning incentives to improve efficiency: Update and further consultation

Network Rail's response

12 July 2012

NetworkRail

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1. INTRODUCTION

1.1. Aligning incentives to improve efficiency

We welcome the opportunity to comment on ORR's consultation on aligning incentives to improve efficiency. There has been a clear recognition that the lack of alignment between Network Rail and its customers is one of the key obstacles to improved value for money. Working together through alliancing, along with devolution, is one of the key enablers of continued improvement in efficiency, and the benefits from these initiatives are largely inseparable from each other.

Network Rail and its partners have already made considerable progress in respect of working together. We have recently established the first 'deep' alliance in Wessex, together with a number of 'framework' alliances. Discussions with many train operators are ongoing, and we are speaking to bidding TOCs as standard as part of the re-franchising process. Similarly, we are going to great lengths to promote transparency of our costs and outputs, and we consider that these moves will encourage further collaborative working. Work is continuing, and we are look forward to strengthening our relationship with train operators even further.

At the same time, ORR is undertaking its own work to align incentives to improve efficiency. For example, it is developing its Route-based Efficiency Benefit Sharing (REBS) mechanism and investigating exposing train operators to Network Rail's costs at future periodic reviews.

In designing the regulatory framework, it is very important that ORR encourages and reinforces the principles of collaborative behaviour that the industry has demonstrated to date. We believe that there is a very fine line between incentive mechanisms that will encourage collaboration and ones that will promote conflict. For example, the way in which REBS and alliancing work together could either align all industry parties behind the same objective, or it could encourage disparate – and potentially divergent – objectives and behaviours. **In establishing the regulatory framework for CP5, ORR should seek a regime that rewards joint-working and cooperation. It should avoid encouraging operators to 'beat us up'.** Beyond promoting joint working, our efforts towards improving transparency will remove the need to create a regime that relies on opposing interests.

This principle is a recurring theme in the remainder to this document, which sets out Network Rail's response to ORR's consultation on aligning incentives to improve efficiency.

1.2. Background

ORR published its first Periodic Review 2013 consultation in May 2011[1]. We submitted a response to that consultation in September 2011[2]. ORR's second consultation was

[1] Periodic Review 2013 first consultation, 25 May 2011. Available at: http://www.rail-reg.gov.uk/pr13/PDF/PR13-first-consultation-document.pdf.
[2] Periodic Review 2013 first consultation – Network Rail's response, 2 September 2011. Available at: http://www.rail-reg.gov.uk/pr13/PDF/pr13-first-consultation-nr-20110902.pdf.

published in December 2011, with a focus on incentives[3]. We responded to that consultation in February 2012[4].

This document contains Network Rail's response to ORR's consultation on aligning incentives to improve efficiency[5], published in May 2012. ORR issued a supplementary consultation on 1 June 2012 describing an additional option for exposing operators to Network Rail's costs as determined at periodic review. This document also contains Network Rail's response to this supplementary consultation.

Network Rail hosted an industry workshop in relation to REBS and alliancing on 21 June 2012. ORR attended this workshop as an observer, with DfT and Transport Scotland also present. This workshop was very informative, and consensus was reached in relation to a number of important areas. We note the main areas of agreement in the relevant sections of this document.

1.3. Structure of this document

ORR framed its consultation around the following headings:

- Update on route-based efficiency benefit sharing (REBS);
- REBS and alliancing; and
- Exposing train operators to changes in Network Rail's costs at a periodic review.

The following chapters are structured along the same lines as ORR's consultation.

[3] Periodic Review 2013 consultation on incentives, 14 December 2011. Available at: http://www.rail-reg.gov.uk/pr13/PDF/pr13-first-consultation-nr-20110902.pdf.
[4] Periodic Review 2013 consultation on incentives – Network Rail's response, 8 February 2012. Available at: http://www.rail-reg.gov.uk/pr13/PDF/pr13-incentives-response-network-rail-response.pdf
[5] Periodic Review 2013 consultation on aligning incentives to improve efficiency, 3 May 2012. Available at: http://www.rail-reg.gov.uk/upload/pdf/aligning-incentives-to-improve-efficiency-0512.pdf

2. UPDATE ON ROUTE-BASED EFFICIENCY BENEFIT SHARING

2.1. ORR's position

In its consultation, ORR summarised its 'minded to' position in relation to REBS. The main features of the proposed mechanism are as follows:

- it would be implemented at a Network Rail operating route level;
- it would cover operating, maintenance and renewals expenditure and potentially some elements of Network Rail's revenue;
- it would be asymmetric, with operators sharing 25% of outperformance and 10% of underperformance;
- operator exposure to both upside and downside would capped at 10% of Network Rail's outperformance or underperformance compared to the efficient expenditure baseline assumed for CP5;
- each individual train operator's share of REBS would be based on its share of variable usage charges paid on the route; and
- membership would be compulsory, except where alliance arrangements were in place or where operators fall below a *de minimis* threshold.

ORR is continuing to consider the level of the caps for freight operators, given their ability to bear risk, and in particular whether there should be a different level of capping for freight operators and whether varying caps could be considered discriminatory. In addition, it is examining the *de minimis* threshold below which operators may be exempt from, or can opt-out of, REBS. ORR has yet to decide on the full scope of REBS, including whether it will include Schedule 4 and 8 costs and/or certain elements of Network Rail's revenue.

2.2. Network Rail's current position

We continue to believe that alliancing will provide the most effective means of incentivising operators to help increase industry efficiency, and note that similar views were expressed by many operators at the 21 June workshop. However, we recognise that REBS will help ensure broad-brush coverage of sharing arrangements, and we will engage constructively on the REBS mechanism going forward.

We welcome ORR setting out its 'minded to' position in relation to REBS. We have identified a number of issues which we believe are especially important and would merit further consideration by ORR before it finalises the regime. We summarise these issues below.

Membership of REBS

A fundamental issue which remains outstanding relates to how REBS membership should be decided. ORR's proposal is that membership in the mechanism should be compulsory, except where alliance arrangements are in place or where operators fall below a *de minimis* threshold.

We strongly believe that membership of the mechanism should be on an ‘opt-in’ basis. We note that there was broad industry support at the Network Rail workshop on 21 June for an opt-in approach to REBS.

This approach is appropriate for a number of reasons:

- On routes where alliancing is present, which we expect will include several routes over the coming years as alliancing becomes more prevalent, it will help ensure that the REBS regime is consistent with the principles of relevant legislation, notably the Access & Management Regulations 2005. We discuss this issue in more detail in the next chapter.

- It will promote industry buy-in and enhance the credibility of the REBS mechanism.

- It is essential that the REBS regime exposes operators to Network Rail underperformance, as well as outperformance, in order to ensure that operators are always incentivised to engage with Network Rail. We recognise, however, that some operators’ business models focus on managing downside risk, so that exposure to Network Rail underperformance could be particularly unwelcome. The opt-in approach would allow operators to run their businesses in the way they see fit, whilst ensuring appropriate incentives across the majority of the railway network.

We understand that ORR is concerned that permitting opt-ins could dilute coverage of sharing arrangements. We note though that ORR believes that “there is more likely to be outperformance due in part to the asymmetric design but also because we expect to establish efficiencies in CP5 that are challenging but achievable”. ORR’s ‘minded to’ position is therefore favourable to operators. We firmly believe that this will ensure a high degree of opt-in, and extensive coverage of sharing arrangements.

Moreover, we recognise that franchise commitments may *require* operators to enter the REBS regime. We would expect franchising authorities to encourage alliancing arrangements as a matter of policy. However, where this is not possible, we consider that it would be appropriate for participation in REBS to be promoted by franchising authorities.

ORR has invited Network Rail to comment on how it sees an opt-in approach working in practice. We consider that opt-ins should be made on a route-by-route basis. They should be permitted at the start of each control period and allowed for entire control periods only. We would envisage a window of opportunity for opting-in which would close before REBS baselines are set.

Inclusion of Schedule 4 and 8 inside the REBS mechanism

An issue which we consider to be of paramount importance is whether Schedule 4 and 8 payments are included inside the scope of REBS. We argued forcefully for the inclusion of Schedules 4 and 8 in the definition of REBS in our response to ORR’s consultation on incentives, and have made this point at various fora, such as ORR’s workshop held on 13 April 2012.

We continue to believe that the inclusion of Schedule 4 and 8 is essential if the REBS mechanism is to operate effectively. Equally importantly, inclusion of Schedule 4 and 8 in REBS will be important in upholding the integrity and effectiveness of the Schedule 4 and 8 regimes themselves.

As we have stated in previous consultation responses, a failure to include these would create a perverse incentive for operators to encourage Network Rail to reduce costs at the expense of performance. This is because operators would be sheltered from worsening performance by Schedules 4 and 8, but would benefit from increased efficiency via REBS. Exposing operators to the tradeoff between performance and efficiency, by including Schedule 4 and 8 payments in REBS, will encourage operators to balance the wider benefits and costs of their actions in their decision-making process. This is a fundamental economic principle which will ensure the continued efficacy of the Schedules 4 and 8 as compensation and incentive regimes, and enhance the incentive effects of REBS.

In addition, ORR is keen to encourage train operators to work with Network Rail to help it improve performance and minimise the number and impact of possessions. A further advantage of including Schedule 4 and 8 payments in the definition of REBS efficiency is that it will sharpen incentives for operators to work with Network Rail in achieving these ends. We understand that ORR will soon commission work that will investigate the incentive effects of including Schedule 4 and 8 in REBS.

Inclusion of property and other revenue inside the REBS mechanism

Given our existing focus on generating more revenue from property and other sources, we consider that the inclusion of property and other revenue in a sharing mechanism would be better suited to bespoke arrangements. REBS should not, therefore, include any of Network Rail's revenue.

Implications of asymmetry

In our response to ORR's consultation on incentives, we argued strongly for a symmetric regime. We continue to believe that a symmetric regime is most appropriate and believe that an asymmetric structure will undermine the credibility and incentive properties of the mechanism. Moreover, it will impose costs on Network Rail, for which it will require funding.

However, we recognise that ORR is minded to implement an asymmetric structure in which operators share 25% of Network Rail outperformance and 10% of underperformance.

We have undertaken careful analysis of the likely financial consequences for Network Rail of this proposed asymmetry of REBS. Our findings are that the asymmetric nature of ORR's 'minded to' regime will impose a total cost of approximately £70m (2011-12 prices) on Network Rail over the course of CP5. This represents a material cost to Network Rail, and one for which we would consider it appropriate to be remunerated. We wrote to ORR in relation to this work on 3 April 2012.

We very much welcome ORR's decision to take account of asymmetry of REBS in deciding Network Rail's overall financial package as part of its PR13 determination.

ORR states that it will also consider the impact of operator effort, which it expects will offset some of the potential costs to Network Rail, in deciding Network Rail's financial package. We understand this point. However, just as Network Rail has based its assessment of the costs of asymmetry on rigorous analysis and evidence, it is essential that any offset as a result of operator effort is decided on the basis of a similar degree of analytical care. We note that, to date, ORR has not produced any evidence or analysis as to the likely impact of operator effort resulting from REBS on Network Rail's efficiency or finances. We would caution that deciding the level of any offset from operator effort without proper analysis could expose Network Rail unduly to risks beyond its control.

Apportioning of outperformance and underperformance

We consider that ORR's proposal that the mechanism would apportion outperformance or underperformance on the basis of variable usage charges by route to be appropriate.

We have made ORR aware of some of the problems associated with mileage and charging data which is currently available by route. These difficulties have arisen because recording information on the basis of the recently devised operating route structure was not envisaged at the time of developing our billing systems. However, we are continuing to improve the quality of our data in advance of CP5.

Regional baselines

We expect ORR to issue the route baseline assessments as part of the PR13 determination. We will produce delivery plans thereafter. We said in our response to ORR's consultation on incentives that we consider that it would be appropriate to adjust the REBS baselines in order to reflect our delivery plans during CP5, in a cost-neutral and transparent way.

We have discussed this issue with ORR recently. ORR has stated that it agrees with Network Rail's position, and that it would be appropriate to adjust REBS baselines to reflect our CP5 delivery plans. We welcome ORR's position in this regard.

Demonstrating contributions to efficiency

We note that ORR envisages exposing operators to the same test for demonstrating their contributions to Network Rail's efficiency as with the EBSM in CP4. We highlighted some of the difficulties and ambiguities associated with this approach in our response to ORR's consultation on incentives.

We recognise the contributions made by operators during CP4, and expect an equally fruitful relationship going into CP5 and beyond. In practice, however, it has proven very difficult and cumbersome to establish a meaningful causal link between individual activities on the part of operators and efficiency savings made by Network Rail. For this reason, we consider that the requirement for operators to demonstrate contributions should be removed, and REBS payments should become automatic to operators which opt-in to the regime on a route. We consider that this should reduce the administrative burden on Network Rail and ORR, as well as operators themselves. In addition, we believe that this will help reinforce the culture of cooperation between operators and Network Rail that we are trying to promote.

However, we understand that ORR may determine that a degree of assurance will be required around operator contributions in CP5. If ORR determines that such an approach is appropriate, we consider that this process should be formalised and a greater degree of structure should be introduced relative to CP4. In particular, ORR should clarify whether individual or collective representations from operators are required, and a template for evidence should be developed.

Reviewing the mechanism

ORR suggests that it will review the REBS mechanism after two years of operation. Whilst we understand ORR's intentions in this regard, we are concerned that this could introduce uncertainty for both Network Rail and operators. We would urge ORR to set out the scope of its planned REBS review, and whether the regime could be changed mid control period in light of the review. It would be helpful if ORR could clarify these issues well in advance of the implementation of REBS in CP5. Train operators may find it helpful for ORR to set out its intentions before they have the opportunity to opt-in.

3. REBS AND ALLIANCING

3.1. ORR's position

In its consultation, ORR stated that it supports the concept of alliances and welcomes their potential to deliver benefits, not only for the parties involved but also for rail users and taxpayers. ORR agreed that secondary operators should be incentivised to support the concept of alliances and work with the alliances to reduce costs.

However, ORR recognised the need to confirm how its proposal for REBS should interact with alliancing arrangements. In this regard, it identified two options for consideration by stakeholders:

- Option A ('REBS excluding alliances' or 'REBS before alliances'); and

- Option B ('REBS including alliances' or 'alliances before REBS').

Option A involves REBS payments being made on the basis of Network Rail's financial performance relative to baseline on a particular route. On the other hand, Option B involves REBS payments being determined by the performance of Network Rail relative to a baseline including alliance contributions.

ORR has asked Network Rail to provide its opinion as to whether Network Rail's preferred option (see below) is in keeping with relevant legislation. ORR has also asked for suggestions as to how some of its own concerns associated with Network Rail's preferred option, together with the concerns of operators, could be mitigated. We address these points below.

3.2. Network Rail workshop on REBS and alliancing

Network Rail held a workshop on the interaction between REBS and alliancing on 21 June at Kings Place. The workshop was desired to promote understanding and discuss the options for REBS and its consequences for alliancing, and give operators and other stakeholders the opportunity to ask questions.

The aim of the workshop was to try and identify things that the industry agreed on in this area, to lessen the burden on ORR to make a decision in relation to this matter. The workshop was well attended by passenger and freight operators alike. ORR attended as an observer, with DfT and Transport Scotland also present.

The workshop was very informative, and consensus was reached in relation to a number of important areas. There was broad agreement that:

- The issue of the interaction between REBS and alliancing is very important;

- The interaction between REBS and alliancing should be kept as simple as possible;

- The order in which REBS and alliancing payments are made really matters; and

- The way in which REBS and alliancing interact will drive behaviours on the ground, both inside and outside of alliances.

Industry delegates agreed a hierarchy of principles for the REBS and alliancing interaction. The first of these was that:

- Alliancing alone, without the need for REBS or a similar default arrangement, would be the ideal setup.

However, there was recognition that, in order to ensure widespread coverage of sharing arrangements, REBS was likely to be implemented in CP5. Recognising that alliancing and REBS are likely to operate concurrently in the next control period, there was broad industry consensus around a second principle:

- Alliances before REBS is the right approach to ensure appropriate behaviours in alliances.

It was recognised that only alliance before REBS guaranteed a REBS payout to non-alliance train operators if the alliance financially outperformed. It was also noted that this option did not create perverse incentives to make savings in one party's cost base over another's.

In addition, delegates agreed that the following alternatives would be two acceptable approaches:

- Alliances before REBS, but with an upside only REBS mechanism to protect operators from downside risk; or

- Alliances before REBS with both upside and downside, but with REBS enacted on an opt-in basis only.

Network Rail reminded delegates that its position is that it supports alliances before REBS with upside and downside, with operators entering REBS on an opt-in basis. Network Rail's full position in described below.

3.3. Network Rail's current position

The way in which REBS and alliancing will interact is one of the central issues facing the industry in the lead up to CP5. There is no doubt that ORR's decision on how alliancing and REBS will work together will have important financial and behavioural implications for Network Rail and operators.

Alliances present one of the industry's principal instruments for achieving efficiency improvements. Getting this issue right should help alliancing succeed. Getting it wrong could mean that alliancing fails to take off at all.

Network Rail has made its position on alliancing and REBS very clear over the course of the last several months. **We consider that Option B or 'alliances before REBS' is the right choice.** We believe that it is right for Network Rail, right for potential alliance partners on a route, and right for third party operators not directly involved in an alliance on that route.

As noted above, Network Rail hosted an industry workshop on 21 June 2012 to discuss this issue. Whilst there was recognition that both options being considered by ORR were associated with a degree of risk, **there was broad agreement that Option B offers a superior solution to Option A.**

We consider ORR's options in detail below, beginning with Network Rail's preferred option.

3.3.1. Option B – Network Rail's preferred option

Where an alliance is present, we regard the main role of REBS as ensuring that all operators benefit from the alliance. It is only Option B, or 'alliances before REBS', which guarantees that non-alliance train operators on a route will always be better-off if an alliance is successful on that route.

Option B has the following specific features:

- It provides the strongest possible incentives for stronger, closer collaboration between all parties on a route, which we consider is of particular importance;
- It does not create perverse incentives to make savings in one party's cost base over another;
- It is simple and keeps transactions costs to a minimum by avoiding the need for complex assurance and accounting transaction processes;
- It does not discriminate against any particular party under the proposals being made by Network Rail;
- If the alliance is financially successful, all parties on a route that have opted-in to the mechanism will benefit financially; and
- It minimises third party exposure to risks.

Mitigating concerns in relation to Option B

Whilst we are in no doubt that Option B is the right choice, we recognise that ORR and operators have some concerns in relation to this option.

ORR has queried whether Network Rail has satisfied itself that its proposal is consistent with relevant EC legislation. Separate discussions between ORR and Network Rail are ongoing in relation to these matters and we do not restate the legal arguments in detail here. We are confident that our proposed approach of 'opt-in' to REBS, combined with Option B, is consistent with the principles of the relevant legislation.

Some stakeholders have raised concerns that Option B will expose third parties or 'non-alliance' train operators to the alliance operator's costs and revenues, which are less visible than Network Rail's. As noted above, we consider that the REBS regime should be on an 'opt-in' basis. This means that any exposure to the alliance operator's cost base will be on an entirely voluntary basis. In light of discussions with operators, we consider that this approach will significantly alleviate third party operators' concerns of exposure to the alliance operator's costs and revenues.

It should also be noted that, even for operators which choose to participate in REBS, significant downside exposure would be unlikely. This is because ORR has indicated that baselines will be set to leave financial 'meat on the bone'. Moreover, given the asymmetric nature of REBS, together with its embedded caps, if any downside exposure was to occur the financial impacts on third parties would be likely to be small.

It should also be recognised that exposure to alliance operators' costs is equally present under Option A, although the calculations of payments under Option A make this link much less explicit. After all, it is the crux of alliances that decisions will be made jointly. Therefore, it is unavoidable that the financial effects of decisions made by the alliance train operator will impact REBS, and thus non-alliance operators on the route.

In contrast to Option B however, Option A will actually *incentivise* the alliance to make decisions that will be to the detriment of third parties on a route. This is because under Option A, it matters financially to the alliance parties whether savings are made in Network Rail's cost base or the alliance operator's cost base. We now turn to Option A, and begin with this issue of it mattering 'where' a cost saving is made.

3.3.2. The risks of Option A

We consider it to be appropriate for ORR to consider the effect of its policy choice on behaviours of potential alliances. Option A creates a strong incentive on the alliance to both 'book' and 'make' cost savings in the alliance operator's cost base rather than its own as this would 'save' Network Rail REBS payments at the rate of 25% on cost savings 'transferred' to the alliance train operator.

For example, under Option A, £100 saved in the alliance party's cost base would yield £100 of efficiency benefits to the alliance. On the other hand, £100 saved in Network Rail's own cost base would yield an efficiency benefit of just £75 (assuming ORR's proposed 25% REBS mechanism and ignoring caps and REBS double-count for this example)[6]. This 'perverse' incentive effect is, therefore, extremely strong.

The implications of this perverse incentive effect are considerable:

- This is contrary to, and undermines, the key aim of alliances, which is to bring together staff from Network Rail and operators and make them focus on joint outcomes irrespective of their 'pay masters'.

- By encouraging the alliance to concentrate on efficiencies in the alliance train operator's cost base, Option A may mean that focus is taken away from reducing infrastructure costs, as is required by relevant European legislation.

- A rigorous accounting transactions process would have to take place in relation to every pound spent by the alliance under Option A. This process would be essential in providing assurance to parent organisations, ORR, government and third party operators that that the perverse incentives associated with Option A were not distorting decisions inside alliances. In essence, an independent body would have to construct a counterfactual of what would have been done if the perverse incentive did not exist, and compare the counterfactual with actual behaviour in an alliance. This process would be highly complex and introduce substantial transaction costs into alliance arrangements, thereby undermining a central purpose of alliancing to remove transactions costs at the infrastructure manager and operator interface.

- As a result of this strong incentive to make efficiencies in the alliance train operator's cost base rather than in Network Rail's own cost base, Option A will itself expose non-alliance train operators to the alliance operator's membership of the alliance. This is because financial effects of decisions made by the train

[6] Under Option B, the alliance payoff is the same regardless of 'where' the saving is made.

operator alliance party will flow through REBS to non-alliance operators on the route (as described above).

- The behaviour that this encourages would adversely affect non-alliance train operators, since REBS payments to these parties could be avoided.

- Option A may not protect minority operators from undue discrimination. Specifically, Option A may present an opportunity to use the REBS mechanism to extract payments from third parties by underperforming on infrastructure costs and outperforming on train operating costs.

The costs and risks associated with Option A do not end with the creation of perverse incentives, and we would like to re-emphasise some of the points that we have made on previous occasions in this regard. These should be borne in mind by ORR in making its decision.

Firstly, as emphasised earlier, it is very important that the industry is encouraged to work together to achieve common goals. Indeed this is a chief rationale for REBS and for alliancing. Option A, however, does precisely the opposite: it encourages Network Rail and the alliance operator to ‘care’ mainly about the alliance operator’s cost base (since the financial benefits are highest for costs saved in the alliance operator’s cost base, as decribed above), and incentivises third parties on a route to ‘care’ only about infrastructure costs (since they are rewarded only for cost savings made with respect to infrastructure).

We are therefore extremely concerned that Option A could undermine industry efforts towards working together, risk creating unnecessary conflict and ultimately hinder the industry’s endeavours to cut costs. In extremis, it could be the case that if ORR adopted Option A, alliances may not be considered viable.

Secondly, even if we ignore the perverse incentive effects described above, Option A exposes minority operators to unreasonable risks on the routes in which they operate. In particular, under Option A the alliance could outperform overall but third parties could fail to benefit – and even lose out – financially.

More specifically, the alliance will seek to minimise costs across its activities as a whole. However, Option A will expose minority operators only to one part of those costs – the infrastructure costs. This structure could expose third parties to substantial risks if the alliance decides to invest in infrastructure in order to drive down whole-alliance costs. For example, an electrification scheme delivering substantial whole-alliance savings (as a result of more efficient rolling stock, reduced fuel costs and so forth) would lead to higher infrastructure maintenance and renewals costs. In this instance, minority operators could pay out through REBS to Network Rail due to infrastructure costs being higher than the baseline, even though the alliance as a whole had made significant efficiencies.

Finally, as described in detail in Appendix 1, Option A has substantial implications for the formation of alliances, and could be discriminatory against smaller operators. Specifically, under Option A, smaller prospective alliance partners could receive a lower proportion of alliance payments than larger ones. For example, if there was a £10m efficiency made in infrastructure costs under an alliance, Option A could involve a smaller operator receiving a lower share of the savings than a larger operator. This puts them at an inherent disadvantage when it comes to negotiating alliances with Network Rail – they will have less ‘bargaining power’ in negotiations. Moreover, Option A may actually dissuade operators from taking part in alliances altogether, since it permits leakage of financial benefits to parties not contributing to efficiencies. These problems are likely to be particularly acute in instances where there is not a dominant operator on a route – and especially where certain operators dominate part, but not the whole, of a route – for example in the case of C2C / Essex Thameside in the Anglia route (see Appendix 1).

4. EXPOSING OPERATORS TO CHANGES IN NETWORK RAIL'S COSTS AT A PERIODIC REVIEW

4.1. ORR's position

ORR is considering how it could expose operators to changes in Network Rail's costs as determined at periodic reviews from CP6 onwards. ORR's rationale for introducing this type of exposure appears to be twofold:

- It could encourage train operators to engage in the price control process to challenge Network Rail's costs and identify sources of efficiency; and
- It could mitigate the possible perverse incentives created by REBS in isolation, whereby operators may be incentivised to argue for a lenient Network Rail efficiency baseline in order to build in 'fat' to the periodic review settlement on the expectation of easier gains through REBS in the subsequent control period.

Two mechanisms are being considered by ORR which would expose operators to Network Rail's costs as determined at periodic reviews.

The first, which we call **Option 1** for the remainder of this response, is a financial sharing regime under which operators would benefit from a proportion of the difference between a baseline and Network Rail's efficient expenditure as determined by ORR at each periodic review.

The second, which we call **Option 2** and was described in a supplementary letter to ORR's consultation, is a simple mechanism through which operators are exposed to Network Rail's variable charges which they can influence. This would be implemented by means of relaxation of Schedule 9 of passenger operators' franchise agreements.

4.2. Network Rail's current position

4.2.1. The need for the mechanism

Whilst we understand why ORR is seeking to expose operators to changes in Network Rail's costs at periodic reviews, we are not convinced that this is necessary or would promote improved industry outcomes relative to existing initiatives. In particular, alliancing and transparency initiatives are already proving to be highly effective means of driving efficiencies, and improving industry outcomes more generally.

Alliancing

Working together through alliancing is a crucial enabler of continued improvement in efficiency. As noted, above, this view is not confined to Network Rail, but is shared by the railway industry as a whole. Even though alliancing is in its infancy, it has already started to bear fruit. For example, the transfer of maintenance activities to Network Rail in Kent is estimated to give rise to a six figure efficiency saving annually. Likewise, revised access planning in 2012-13 in Anglia is expected to save substantial Schedule 4 costs to Network Rail and increase operator revenue.

We consider that ongoing work in respect of alliancing considerably diminishes the need for a mechanism which exposes operators to Network Rail's costs as determined at periodic reviews.

Transparency

We are going to considerable lengths to improve transparency in relation to our costs and outputs, particularly at route level as part of the devolution process. For example, our regulatory accounts now provide detailed financial data by route, and we recently published information on budgets and costs for high profile projects, made real-time train running data available for the first time, and started the process of putting out more granular performance information, beginning with right time figures by sector earlier this month. We believe that these initiatives will improve our accountability and increase trust in Network Rail, facilitating more effective collaboration with train operators. This will in turn give rise to cost savings.

Equally importantly, this process of promoting transparency will enhance the volume and coverage of information available to ORR in making its periodic review determination, as well as increasing the likelihood of us being held to account by others e.g. passengers and the public at large, outside the regulatory relationship. As such, it will greatly reduce the need for ORR to rely on operators to challenge Network Rail's costs through the periodic review process.

It should be stressed that these benefits of transparency will be magnified further in the presence of alliancing. This is because, where alliances exist, our efforts towards increasing transparency will mean that the effects of alliancing will also be present in the information available to ORR for devolved routes.

Avoiding conflict

We are concerned that some of the mechanisms that ORR is considering may undermine collective efforts to save costs. As discussed, below, some of the mechanisms being considered by ORR, rather than rewarding joint-working, actually incentivise operators to work *against* Network Rail. This could jeopardise achievements to date, and discourage future collaboration.

Developing the evidence base

With the exception of a small number of qualitative examples, we note that ORR has not presented any evidence around the likely efficacy of the regimes it is considering implementing. We would encourage ORR to develop the evidence base before taking this work further. This could involve detailed analysis of other industries and work around the likely impacts in the rail industry, for example by means of explicit conversations with stakeholders around their likely responses to such regimes.

4.2.2. Evaluating the Options

We recognise that development of the prospective mechanisms is in its infancy, and that a great deal of further development and consultation will be required before any mechanism could be made operational, if one was to be implemented at all.

It is unclear whether ORR envisages the two options, described above, being implemented simultaneously, or whether they are to be regarded as alternatives. We do not consider that it would be appropriate for both approaches to be implemented concurrently. For the purposes of this response, we will regard these options as being alternative to one another.

As discussed in detail, below, we do not believe that Option 1, or a similar mechanism, would be appropriate. We would oppose the introduction of Option 1 or a similar structure.

We support the notion of exposing operators to our costs by means of a relaxation of Schedule 9, as under Option 2. However, we consider that the chief purpose of doing so would be to internalise the variable costs faced by operators to encourage decision-making on the basis of market signals, which should enhance economic efficiency. This is in contrast to ORR's stated objective of encouraging operators to engage in the periodic review process.

We set out, in the following section, our reasons for opposing Option 1. We then go on to offer detailed comments on the two options.

4.2.3. The risks of Option 1

We strongly believe that Option 1 should not be taken further by ORR. We set out our reasons, below.

Encouraging collaborative working

There has been a clear recognition that the lack of alignment between Network Rail and its customers is one of the key obstacles to improved value for money. Devolution and alliancing are therefore two of the key enablers of continued improvement in efficiency. The benefits from these two initiatives are largely inseparable from each other.

The benefits stem from more local decision making by Network Rail which in turn should enable more effective engagement and alignment with customers. This starts with an improved understanding of each others' businesses so there is a better understanding of areas of mutual benefit. This understanding has already proved sufficient to enable change. For example, we have been able to agree a reduction in lightly-used late night mid-week services which make maintenance very difficult, in conjunction with an expansion of much more valuable weekend services.

Beyond this, for example, it is important to Network Rail that operators have an incentive to engage with us on the development of our asset management plans so that we can properly prioritise our work. We therefore support our customers having a share of the benefits from improved efficiency so that they can help us to achieve these benefits. This is fundamentally about alignment of infrastructure management and train operations by enabling each to share in the success of the other without changing their respective accountabilities.

However, the opportunity is sometimes presented as creating an incentive for operators to put greater pressure on Network Rail to reduce costs or to provide evidence to ORR on the potential for cost reduction. In our view, there is a danger that this alternative perspective could lead to the reintroduction of conflict when we are seeking to achieve alignment. This could create an incentive for operators to engage with ORR on the potential for efficiencies rather than working with Network Rail to help realise efficiencies as quickly as possible. As well as being damaging, this could also be of limited benefit to ORR given the much greater transparency which devolution and alliancing will create around efficiency and performance at a local level.

4. EXPOSING OPERATORS TO CHANGES IN NETWORK RAIL'S COSTS AT A PERIODIC REVIEW

We would urge ORR to guard against implementing any mechanism that puts Network Rail and operators in conflict. We consider that Option 1 in particular will put operators and Network Rail at 'loggerheads' at a time when the industry should be working towards common goals. We consider that Option 1 runs in the face of recent industry initiatives such as alliancing, promoting transparency and the establishment of the Rail Delivery Group. This mechanism could be a setback to the achievements of the industry to date, and would aggravate future moves towards closer collaboration, especially through alliances.

Value for money

We are confident that alliancing and other forms of joint working will offer the best value for money for funders and passengers over the long term. The really large savings will be realised through collaborative efforts rather than encouraging TOC participation at periodic review. This view is echoed across the industry, as noted above. In contrast, Option 1 incentivises operators to work against Network Rail and could lead to windfall payments to operators rather than funders and railway users.

In principle, benefits experienced by operators through Option 1 should flow back to taxpayers by means of more favourable franchise bids. In practice, however, in light of the uncertainty surrounding the mechanism and the move to longer franchises, it seems unlikely the regime would increase bidder value substantially.

Simplicity

We have appealed to ORR to design a regulatory regime which is as simple as possible, whilst maintaining the appropriate incentives on Network Rail and train operators. Option 1 would require the establishment of a complicated financial mechanism on top of an already complex regime. This is likely to require substantial outlays of resources for the industry to understand the regime and ensure that it is fit for purpose. Recent industry considerations about the relationship between REBS and alliancing have highlighted some of the problems and complexities associated with imposing multiple financial sharing mechanisms on top of each other. The industry should avoid the creation of further complexity.

Establishing the baseline

Setting the baseline for this mechanism will be crucial. However, as discussed, below, setting the baseline is likely to involve tradeoffs between protecting funders and rail users on the one hand, and avoiding gaming and creating perverse incentives on the other. The intrinsic problems in setting the baseline detract even further from this mechanism as a viable prospect.

Perverse incentives

As the regulatory regime becomes more complex, and interactions between regulatory mechanisms become more numerous and complicated, unintended and sometimes perverse incentives can be created. The inherent complexity of Option 1, together with the way in which it will interact with other mechanisms such as REBS, alliancing and so forth, make it particularly susceptible to introducing unintended effects.

4.2.4. Option 1 – detailed comments

We do not consider that Option 1 should be taken further. However, since ORR has asked for stakeholders' views on the detail of the mechanism, we provide further comments here.

Overall, we believe that such a mechanism should be based on the following principles:

- Operators should be rewarded for efficiencies over and above savings that would anyway have been delivered;
- Operators should be rewarded for identifying specific 'bottom-up' initiatives that deliver genuine savings;
- Operators should be rewarded for 'reporting' initiatives that could improve efficiencies at the earliest possible opportunity, and should be encouraged to share those initiatives directly with Network Rail;
- The mechanism should be simple; and
- The regime should mitigate against perverse incentives that may be introduced by other mechanisms, notably REBS, and not induce further perverse incentives.

In light of these principles, we make the following specific comments.

Assessing contributions to efficiency and timing of payments

REBS aligns incentives across the industry and encourages Network Rail and operators to work together. This is a highly desirable end in itself. The mechanism being considered by ORR under Option 1 does not possess this feature, and indeed could create conflict. Moreover, and in contrast to REBS, this mechanism is likely to be 'upside only'.

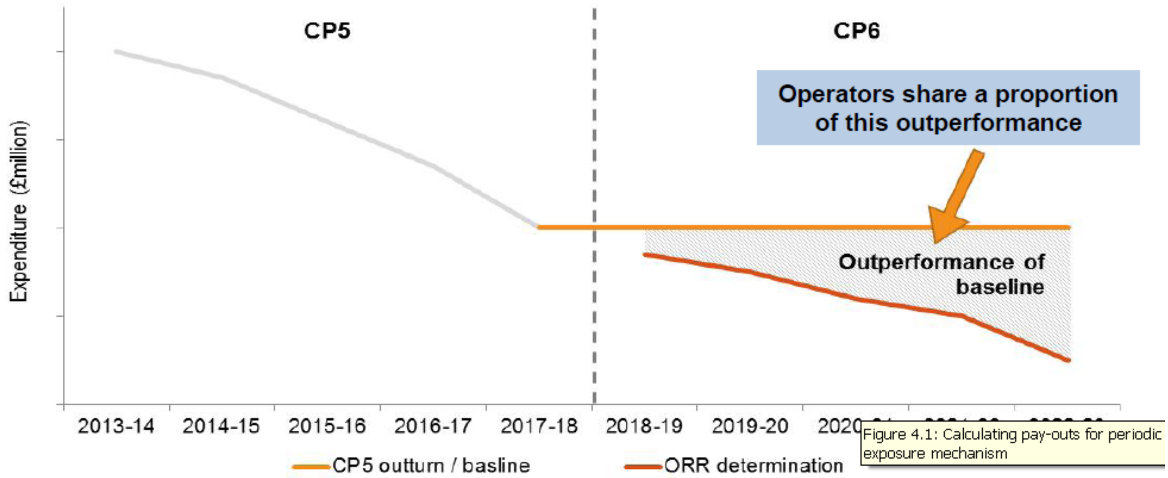
It is therefore appropriate that operators only share in efficiencies where they have made a clear contribution to achieving those savings, as opposed to sharing them automatically as envisaged under REBS. **Rewards should only be conferred for identifying genuine bottom-up efficiencies.**

Moreover, in order to avoid payments being made on the basis of speculative proposals, and to incentivise the identification of initiatives with real chances of success, payments should be made *after* the realisation of efficiency gains. Payments should not be made if a scheme identified by operators does not achieve the expected efficiencies.

Defining the baseline

ORR envisages the baseline for sharing as "the relevant cost base for the following control period that is 'frozen' at the end of the preceding control period, reflecting the prevailing level of demand, outputs, asset policies and efficiencies at that point". Figure 4.1 from ORR's consultation illustrates the baseline, and is reproduced below.

Figure 4.1: Calculating pay-outs for periodic review exposure mechanism



We do not believe that this choice of baseline is appropriate, particularly because it does not reflect efficiencies that would be delivered anyway. This choice of baseline is liable to overstate the efficiencies that could be facilitated by operators. By linking operators' payouts to efficiencies that may have been delivered anyway, this approach could put at risk part of the savings that would otherwise have benefitted funders and railway users.

Setting the *right* baseline will be a particularly difficult task. One the one hand, the baseline needs to be set well in advance so as to avoid 'gaming' and provide certainty to the parties involved. On the other hand, it should reflect efficiency savings that would anyway have been identified – information on which may not be available until relatively late in the periodic review process – so as to protect the interests of funders and railway users. As noted above, this inherent difficulty in establishing the baseline is another significant drawback for this mechanism.

Defining the scope and sharing rules

ORR invites views on the scope of the regime and the appropriate sharing rules, should it be implemented. Assuming that the baseline is set at a level which reflects efficiencies that would be delivered anyway, it would be appropriate for both the scope of the mechanism and the sharing rules to be consistent with REBS. This would result in a 'rolling' incentive mechanism. This would mean that, in nominal terms at least, the incentives to identify savings would be constant across time and there would be no particular incentive to identify savings through REBS versus the pre-control period sharing mechanism. This would guard against distortions in which operators would wanted to see 'fat' built in to Network Rail's baselines and mean that operators were incentivised to 'report' opportunities as soon as they arose.

Identifying Network Rail's efficient costs

Taken in isolation, it is clear that the Option 1 mechanism would encourage operators to argue for an ORR determination that is as austere as possible, since doing so would maximise the payout to operators. Clearly, that is not helpful from a whole-industry perspective. Indeed, to the extent that it would put operators and Network Rail in conflict at a time when so much effort is being put into having the industry work together, this could be regarded as particularly unhelpful.

Instead, the regime should incentivise operators to help identify Network Rail's *true efficient costs*. This gives rise to another reason for allying the sharing rules with those of REBS. Doing so would mean that operators would be encouraged to identify genuine savings only, and at the same time would not be incentivised to 'hold back' on identifying such savings during the periodic review.

Deadbands

ORR is considering a 'deadbands' approach, under which the share of outperformance given to operators increases as the level of outperformance rises. The idea appears to be that the rewards to operators would be relatively modest for identifying 'low hanging fruit', but would increase for identifying further efficiencies which may be more difficult to come by.

We strongly oppose the use of such an approach. As ORR rightly notes in its consultation, this would introduce considerable complexity into the regime. For the same reasons as discussed above, this increased complexity would be very unwelcome.

Moreover, a deadbands approach would be entirely incompatible with a 'rolling' incentive regime, and could reward operators to perversely 'time' reporting efficiency initiatives.

The introduction of the nonlinearities described by ORR also introduces a number of decisions which would have to be taken relating to:

- where the 'kinks' in payment curves should be located; and
- the strength of the incentive, as determined by the share of outperformance given to operators, over different ranges of performance.

Such decisions would have to be made on the basis of careful analysis. This is likely to be very time-consuming and costly. Moreover, even the most careful investigation is unlikely to be able to underpin these important decisions with the required degree of confidence. Getting these decisions wrong could mean that funders and passengers lose out, and risks misaligning costs and benefits so that the implied incentives are not the right ones.

4.2.5. Option 2 – detailed comments

As noted, above, we support the notion of exposing operators to our costs by means of a relaxation of Schedule 9, as under Option 2. However, we consider that there are stronger reasons for doing so than encouraging TOCs to participate more deeply in the periodic review process.

We have a number of comments around the more specific features described by ORR in its supplementary consultation and consider that further development of ORR's thinking is needed. We set out our position, below.

Exposure to variable costs only

ORR's consultation describes exposing operators only to Network Rail's variable costs as determined at periodic review. We note the following:

- Managing railway infrastructure is associated with very large fixed costs, and exposing operators only to the relatively modest variable component seems arbitrary, and may limit incentive effects.

- Exposing operators only to variable charges would be likely to encourage opposition to the introduction of new variable charges, even if those charges could promote cost reflexivity and send appropriate price signals to operators.

- Similarly, exposing operators only to variable costs could have the unintended consequence of incentivising operators to lobby for a larger proportion of costs being classified as being fixed. This could undermine efforts to develop a charging structure which is more costs reflective.

Overall, we consider that it would be appropriate for ORR to develop its proposals by considering how operators could be exposed to Network Rail's fixed costs through charges.

EC4T

Whilst further work should be done in relation to fixed costs, for some variable charges there is already a compelling case for exposing operators by means of relaxing Schedule 9. EC4T charges, for which Network Rail effectively acts as an agent for operators, is a useful example. We agree with ORR that this reform would provide a strong incentive for the introduction of further on-train metering, and would encourage Network Rail to manage infrastructure transmission losses efficiently.

Schedules 4 and 8

Exposing operators to Schedules 4 and 8 is different to exposing operators to charges, since these regimes are calibrated so as to hold train operators harmless if the relevant outputs are delivered. We said that there could be a case for exposing TOCs to changes in costs relating to Schedules 4 and 8 in our response to ORR's first PR13 consultation. We continue to believe that this could be appropriate. This would incentivise operators to ensure that payment rates are correct at a regulatory review, align incentives in relation to performance and possessions, and promote improved performance among operators.

Geographic disaggregation of charges

ORR is already considering the disaggregation of variable usage charges across operating routes. We strongly oppose this and have made our position very clear to ORR. We note that imposing geographically varying charges, and at the same time exposing operators to costs by means of relaxing Schedule 9, will create 'winners and losers' among operators, and is likely to be subject to fierce opposition. ORR should be mindful that, by exposing operators to different charging regimes across different geographies, this combination of policies could impose additional risks on operators. This could have implications for franchise values.

4.2.6. Timing of changes

We welcome ORR setting out its proposals in relation to exposing operators to changes in Network Rail's costs at periodic reviews. It is important that these conversations begin at an early stage. However, we note that the structure of Network Rail's access charges is currently under review, for example in relation to the possible geographic disaggregation of VUC and the introduction of a scarcity charge. This review of charges will not be concluded until well after PR13, and relates closely to the issues being considered as part of ORR's current consultation. We consider that it would be appropriate for ORR to make its decision about the charging structure and exposing operators to Network Rail's efficient costs concurrently – a decision in relation to exposing operators to changes in Network Rail's costs as determined at periodic reviews should not be made until PR13 has been concluded. We note that this was supported by colleagues at a recent meeting of the RDG subgroup on rail reform.

APPENDIX 1

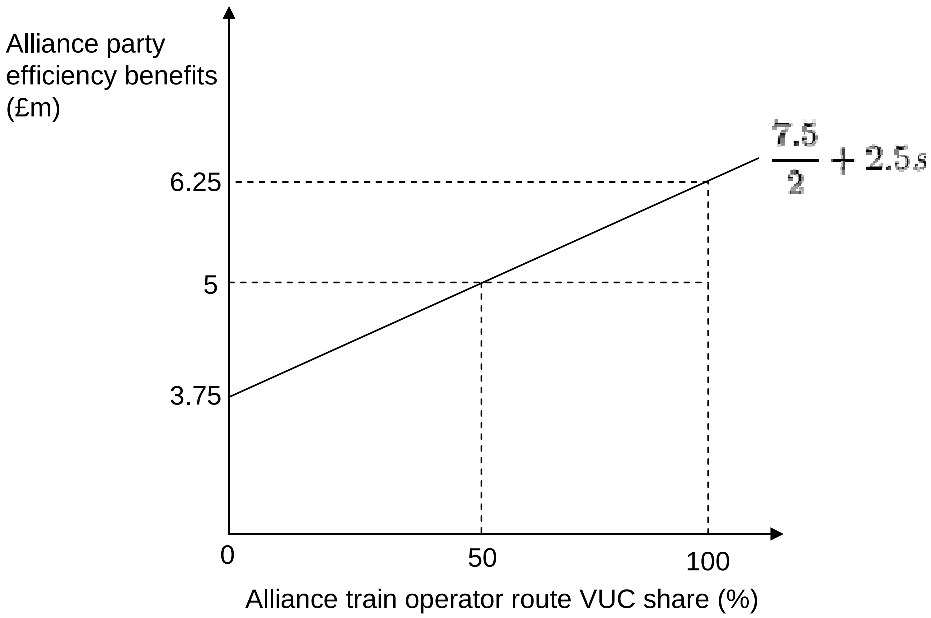
Option A: Potential discrimination against smaller operators

This appendix provides an illustration of the consequences of Option A (REBS before alliances) for the formation of alliances. It does so by examining the financial implications for a potential alliance train operator. The consequences of Option A are that (i) smaller operators are likely to be put at a distinct disadvantage in forming an alliance and (ii) alliances may not take place at all, even though there are industry-wide benefits to be gained. Option B (alliances before REBS) does not suffer from these problems, since the gains to the alliance party are expected to be invariant to REBS payments.

Consider a situation in which all savings on a particular route are made inside an alliance, and that these gains are on infrastructure costs. For illustrative purposes, suppose that the outperformance is £10m[7]. Under Option A, £2.5m will flow into REBS automatically, with the remaining £7.5m being split 50/50 between Network Rail and the alliance operator. The alliance operator will then receive its share of REBS as usual, although it may be appropriate to cap the payments it receives in order to avoid double count. Therefore, the alliance operator will receive financial rewards of

$$\frac{7.5}{2} + 2.5s$$

where *s* is the VUC share of the alliance operator in the route. This is illustrated in the diagram below.



The crucial point is that the lower the alliance train operator's VUC share, the lower will be its rewards from alliancing with everything else held equal. This has two important, and highly undesirable, corollaries.

The first implication relates to possible undue discrimination against smaller operators. The fact that smaller operators will receive lower percentage shares of benefits from

[7] The argument holds for any level of outperformance.

alliancing will put them at an inherent disadvantage when it comes to negotiating alliances, not to mention the obvious disadvantages of making less money than larger operators once an alliance has been formed. This is in spite of the fact that – the arrangements of Option A aside – they may well be the operators that are best placed to form a successful alliance.

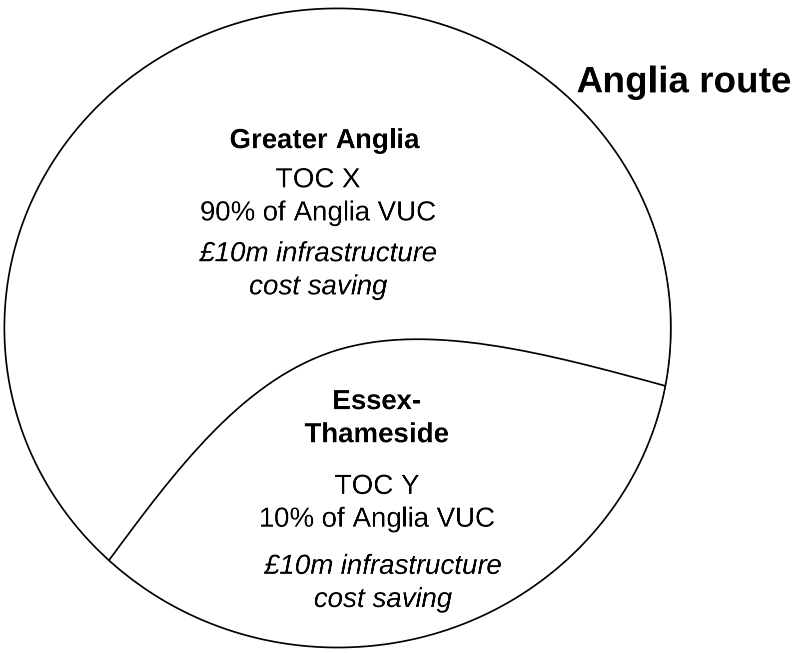
The second issue is that Option A may preclude an alliance from forming in the first place, simply because there may not exist a sufficiently large operator to make an alliance worthwhile. For example, suppose that the alliance party had to incur costs of £4.5m annually in order to partake in the alliance. Any operator with a VUC share of less than 30%[8] on a route would make a loss by forming the alliance. If no operator with a market share above 30% existed on a route, there would be little prospect of an alliance emerging, even though it is beneficial from an overall efficiency point of view.

Note that under Option B the alliance operator would receive the same payment (£5m in the case above) regardless of its size, so that these issues are not present.

Live issue: Essex-Thameside

This problem can be illustrated by considering a live issue in the Anglia route. The following discussion provides a simplification of the situation on the ground in order to isolate the principal concerns, but captures the main point that smaller operators are likely to be disadvantaged.

The Network Rail Anglia operating route contains two franchises: Greater Anglia and Essex-Thameside. For illustrative purposes, we assume that there are just two TOCs in the Anglia route. TOC X operates the Greater Anglia franchise and accounts for 90% of VUC on the Anglia route as a whole, and TOC Y operates the Essex Thameside franchise accounts for 10% of VUC in Anglia. This is summarised in the diagram below and is a fairly close approximation of reality.



[8] Equating the equation above with 4.5 and solving for *s*.

Suppose that alliances are formed with TOC Y in Essex Thameside and TOC X in Greater Anglia – alliances are formed with the dominant operators on each part of the Anglia route. Suppose that each of the alliances achieve a £10m reduction in infrastructure costs.

Consider first the £10m savings in Essex Thameside. £2.5m flows into REBS, with 10% or £0.25m going to operator Y (and 90% or £2.25m going to operator X). The remaining £7.5m is split equally between Network Rail and operator Y (the alliance operator in Essex Thameside). Hence, operator Y ends up with £0.25m+£3.75m=£4m (operator X receives £2.25m).

Now consider the £10m savings in Greater Anglia. As before, £2.5m flows into REBS, with 10% or £0.25m going to operator Y (and 90% or £2.25m going to operator X). The remaining £7.5m is split 50/50 between Network Rail and operator X (the alliance operator in Greater Anglia). Hence, of the £10m savings in Greater Anglia, £2.25m+£3.75m=£6m goes to operator X[9] (and £0.25m to operator Y).

Overall therefore, operator X receives £7m of efficiency benefits and operator Y receives £4.25m. Under Option B, each operator would receive £5m, or half of the realised savings on each route. This information is summarised in the table below.

Total benefits per operator (£m)	Option A	Option B
Operator X	4.25	5
Operator Y	7	5

This discussion illustrates our concerns around option A in the context of a real and ongoing scenario on the ground. It makes the point that smaller operators are likely to be disadvantaged by Option A, and more generally how Option A could frustrate the process of alliance formations going forward.

[9] In practice, caps may be imposed to ensure no double count through REBS. In this case, operator X's payments could be lower. Since caps are unlikely to be set below 50% of efficiencies, the fact remains that the larger operator will receive higher financial benefits than the smaller operator for contributing to the same efficiencies.