Paul McMahon
Office of Rail Regulation
One Kemble Street
London
WC2B 4AN

Peter Swattridge
Network Rail
Kings Place
90 York Way
London
N1 9AG
T +44(0) 20 3356 9327

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Dear Paul,

Sharing Network Rail's efficiency with operators

Thank you for the opportunity to participate in the efficiency sharing workshop that took place in ORR's offices on Friday, 23 September 2011. Listening to the views and concerns of operators and ORR was very helpful, and the purpose of this letter is to expand on some of the points that were made at the workshop.

Network Rail is committed to reducing industry costs. Consistent with this we have already started to devolve substantial responsibilities to the routes. We believe that this will be a key enabler for closer working relationships, 'on the ground', with our customers.

<u>Bespoke or formulaic?</u>

As we discussed in our consultation response, we believe that a mechanism by which operators and Network Rail have an interest and share in each others' costs and revenues will be a key enabler to incentive alignment. We noted that experience from elsewhere suggests that the parties involved need to be able to agree and determine between themselves the specifics of how each alliance should operate, and that a universal approach may not, therefore, represent the 'first best' solution.

We would stress that while we are not ruling out a formulaic, regulatory imposed mechanism, at this stage, we think that there could be more merit in exploring the benefits of a 'horses for courses' approach to cost and revenue sharing, to recognise that what is right for one part of the network, may not be appropriate for other parts. This raises a key question of whether the default agreement should be with or without a formulaic efficiency sharing approach, at a national or regional level.

There appeared to be support at the workshop for the bespoke and formulaic approaches to efficiency sharing being complementary to one another. In our view, if a default formulaic approach were to be included in Track Access Agreements as standard, it would be important to be sure that this would not prevent or discourage attainment of the ‘first best’ solution.

In our view this is a fundamental question to assess, as the discussions on efficiency sharing progress during PR13. In particular, as an industry, we will need to understand what is required to facilitate the ‘first best’ solution, including for example:

- changes to train operators’ franchise specifications to allow more flexibility to agree mutually beneficial arrangements;
- the establishment of a ‘systems operator’ mindset within Network Rail so that decisions around the best use of the network at a local level do not compromise the wider network or other operators; and
- how the regulatory framework can support and encourage these arrangements.

I noted that some workshop attendees were concerned by bespoke cost and revenue sharing arrangements, particularly cross-network operators and those not involved in alliancing arrangements. Our consultation response proposed that there could be merit in the industry agreeing some high-level principles for cost and revenue sharing arrangements (which could include principles such as not unduly discriminatory and high level transparency of arrangements, for example). In combination with the list of considerations, above, we believe that this approach could go a long way to addressing these concerns.

I also note that we are progressing bespoke arrangements for CP4, and we are keen that the development of a potentially universal solution for CP5 should not prevent such arrangements from being implemented.

<u>Practical issues with a formulaic approach</u>

If a formulaic, regulatory imposed approach to cost and revenue sharing were to be adopted, crucially, the design of the mechanism must sufficiently incentivise Network Rail and operators to actively work together to reduce costs and increase revenues.

We recognise the concern expressed by some franchised operators that a symmetric mechanism would introduce undue regulatory uncertainty into the franchise bidding process, particularly given the current lack of flexibility in franchises to adjust service patterns and outputs in response to downside shocks. On this basis, an asymmetric mechanism could be more appropriate (particularly given the concerns raised by other operators that the risk exposure resulting from a symmetric mechanism would be unmanageable), although in our view it further highlights the need to consider the proposals alongside changes to franchise specifications, and that flexibility in this area is very important.

<u>Risk management</u>

Our consultation response highlighted our concern (in relation to an upside-only or asymmetric mechanism) regarding Network Rail's risk profile, if we lost our ability to manage route outperformance and underperformance as a 'portfolio'. We would stress again that we believe we should continue to be allowed to manage the risks of our portfolio of routes (for England and Wales), by centrally pooling outperformance and underperformance, and that a regional formulaic mechanism should not prevent being able to make such trade-offs.

There seems to be some confusion about this in the industry. As you know, we believe there is strong merit in a symmetric approach to risk sharing, rather than just sharing the upside. We believe that this is important. However, it is a separate matter as to whether Network Rail is allowed to manage the portfolio of risks which it retains. Allowing Network Rail to manage risks as a portfolio should produce a cheaper industry solution, and would not favour any one particular approach to risk sharing with operators.

<u>Next steps</u>

At the workshop, ORR explained that it planned to issue a consultation on incentives in November 2011, which would include develop further the ideas and options for efficiency sharing. In the meantime, if you would like to discuss this letter, or the comments we made in relation to efficiency sharing in our response to the first PR13 consultation, please do not hesitate to contact me.

We look forward to engaging with ORR and the industry further on these issues.

Yours sincerely

Peter Swattridge
Head of Regulatory Economics