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Tuesday, 24 April 2012

Dear Paul

Efficiency Benefit Sharing and the Wessex Alliance during CP4

We would like to thank you for the opportunity of presenting at the alliance and efficiency benefit sharing workshop on Friday 13 April 2012. We found the debate to be very helpful.

Our proposal for CP5

At the workshop, we presented what we believe to be the right approach to calculating efficiency benefit sharing payments in the presence of an alliance on a route for CP5. As we said at the time, we believe that the 'alliance adjustments before REBS' approach – in which route costs used in REBS calculations take account of debits and credits between alliance parties – offers the best overall solution. Its advantages are manifold:

- all operators on the alliance route are incentivised to encourage the success of the alliance;
- all operators on the alliance route will benefit if the alliance is successful;
- it does not distort behaviours in the alliance e.g. it does not 'matter' where in the alliance a cost is saved; and
- it will protect minority operators from worrying about whether cost savings are made by Network Rail or the alliance train operator.

We believe that this approach should be adopted for all alliances from the beginning of CP5, when the REBS mechanism is likely to come in to force.

However, we recognise that operators may have concerns around alliance set-up costs and importing risks from the alliance operator in the short term. At the same time, we are eager to ensure rapid implementation of the Wessex alliance so that focus can turn swiftly to fulfilling the alliance objectives and realising its benefits. This will allow us to learn from the experience in time to inform the start of CP5. We are, therefore, proposing an interim arrangement for the remainder of CP4 for the Wessex alliance. This arrangement will protect non-alliance parties in the short term, whilst



continuing to expose them to outperformance that would anyway have been achieved by Network Rail in Wessex, had the alliance not taken place.

Proposal for Wessex alliance in CP4

For the Wessex route for the remainder of CP4 (2012-13 and 2013-14), we propose that calculation of the 'costs' for the Wessex operating route entering the efficiency benefit sharing mechanism (EBSM) follows a number of steps, as below:

- Step 1 – use Network Rail's 'pre-alliance' or 'ex-ante' baseline expenditure for Wessex.
- Step 2 – calculate outturn or 'ex-post' expenditure by route, using a standard apportioning methodology.
- Step 3 – sum the ex-post expenditure across routes, but for Wessex replace 'ex-post' expenditure with the 'pre-alliance' or 'ex-ante' baseline expenditure described in step 1.
- Step 4 – compare this sum to national PR08 efficiency assumptions, with outperformance entering the CP4 EBSM.
- Step 5 – apportion operators' shares of outperformance using national VUC percentage share.

This procedure should be applied to opex and maintenance only in England & Wales, with renewals and income left unaffected. The Scotland EBSM will be unchanged by this framework.

The 'alliance adjustments before REBS' approach, which we explained in our response to ORR's second PR13 consultation, should then be implemented in Wessex from the beginning of CP5.

Why is this proposal appropriate?

We consider that this transitional arrangement offers a pragmatic way forward. It will allow the Wessex alliance to progress quickly, whilst not constraining discussions about how alliancing and REBS should work together in CP5. We would emphasise that:

- the proposal will protect non-alliance operators from risks associated with the Wessex route making a negative contribution to the England & Wales EBSM due to, for example, fixed costs incurred in the first years of the alliance;
- the proposal continues to expose non-alliance operators to Network Rail's CP4 'pre-alliance' out-performance;
- the proposal offers operators protection from alliance set-up costs; and
- the proposal removes possible double payments to the alliance party (through the alliance sharing mechanism and NEBS).

We would be happy to meet with you to discuss this issue further. If you have any questions in the meantime, please do contact me on the number above.

Yours sincerely

A handwritten signature in dark ink, appearing to read 'Peter Swatridge', with a stylized, cursive script.

Peter Swatridge
Head of Regulatory Economics