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Office of Rail Regulation  
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Dear Jonathan,

### **Aligning incentives to improve efficiency**

Go-Ahead welcomes the opportunity to respond to the consultation on 'Aligning incentives to improve efficiency'. We have already engaged with both the ORR and Network Rail on this subject through participation in the industry workshops that have been held. Our response builds on the issues already discussed in these sessions.

This response also represents the response of London Midland, Southeastern and Southern.

In our view, there are four key areas that need to be considered by the ORR as part of their determination regarding route level efficiency benefit sharing (REBS).

- The exposure of operators to downside risk through underperformance;
- The relationship between REBS and the benefits accrued through Alliances;
- How REBS fits in with the overall CP5 Regulatory settlement; and
- Upside benefit sharing arrangements for operators through the Franchise Agreement.

We address each of them in turn in this response.

#### ***The exposure of operators to downside risk through underperformance***

The proposals for REBS have been drafted with the intent for operators to have a financial incentive to influence the performance of Network Rail. Consequently, the current proposal includes both exposure to upside benefit through over performance and downside financial risk in the event of Network Rail under performance.

We have significant concerns over the exposure of franchises to Network Rail under performance.

Firstly, while we will always seek to work in a cooperative manner with Network Rail, identifying opportunities to deliver outputs in the most efficient manner and engaging in constructive challenge, our scope to significantly influence the delivery of Network Rail is limited. Therefore, exposing a franchise to under performance by Network Rail may expose the franchise to a financial risk outside of their control. Our scope to influence is constrained by a number of factors, including but not limited to, our contractual obligations to the government through our Franchise Agreement and the required Network Rail performance set through the regulatory settlement.

Secondly, and looking forward to the potential for deep alliances between operators and Network Rail, operators on a route who are outside a deep alliance could be exposed to the under performance of the alliance, which in turn may be driven by the under performance of the dominant operator in the deep alliance. This scenario could materialise under 'Option B' whereby REBS payments are determined by Network Rail performance including alliance contributions.

Therefore, we do not believe it is appropriate for franchise operators to be exposed to down side financial risk through REBS.

In the event that the proposal to introduce downside risk is retained, then we cannot support 'Option B' as proposed by Network Rail. In this eventuality 'Option A' should be introduced i.e. REBS adjustments made before Alliance adjustments. We note that 'Option A' is not Network Rail's preferred outcome.

***The relationship between REBS and the benefits accrued through Alliances***

The interaction between REBS and Alliances is of significant importance. At the current time the scope of savings that can be achieved through alliances is still emerging, and of particular relevance in relation to REBS is where those savings will be accrued.

As set out in table 3.1 of the consultation document, a range of different scenarios and scale of payments are achieved depending on which party accrues the benefits under an alliance arrangement, or indeed under performs. In our view, given the range of scenarios and financial consequences, further more detailed modelling should be undertaken before a definitive preferred position can be determined.

The impact of different scenarios needs to be considered both for majority operators (assumed to be in an alliance) and minority operators outside an alliance. It should be noted that minority operators can operate a significant proportion of services on some routes and it is important that the REBS mechanism does not create perverse incentives on any operators to form or remain outside alliances.

Furthermore, it is not clear yet whether the interaction between REBS and alliances creates incentives (positive or perverse) on either Network Rail or an operator in an alliance to book costs or savings to one party or another. This needs to be considered in relation to both Network Rail attainment against its regulatory target and to franchise operators against their Franchise Agreement.

The purpose of REBS is to provide an incentive to both Network Rail and operators to over perform (and avoid under performance). The illustrative numbers provided in table 3.1 are helpful in showing the range of scenarios that could occur, however they do not illustrate the impact relative to the overall financial position of either the operator or Network Rail route. To that extent, again further modelling should be undertaken to determine the true incentive that REBS will provide.

Our view therefore is that further analysis is required before a clear view can be formed concerning the respective merits of Option A and Option B, and that this analysis cannot be undertaken in isolation and must also consider the overall regulatory settlement and the relationship franchise operators have with government through their Franchise Agreements. We discuss these points further below.

***How REBS fits in with the overall CP5 Regulatory settlement***

REBS is but one element of the CP5 process. This process is still ongoing and consequently it is difficult to assess the true impact of REBS as the extent of over or under performance will be determined to some extent by the level of efficiency savings required of Network Rail during the Control Period.

To illustrate, in the event that Network Rail are set very challenging efficiency savings during the Control Period, the scope to over perform is limited even with the further contribution that alliances can make. Conversely, a less challenging efficiency saving target creates a higher likelihood of over performance and the opportunity for financial upside through REBS. REBS may therefore provide the incentive to deliver higher levels of efficiency savings.

It would seem perverse for the efficiency savings targets for CP5 to be set at a level where REBS can provide an incentive if analysis suggests that such a level can be actually achieved. An operator would be unlikely to benefit either in this scenario as the receipt of REBS payments are likely to be factored into the bid premium or subsidy line of the franchise.

***Upside benefit sharing arrangements for operators through the Franchise Agreement***

REBS and Alliances are expected to provide the framework through which both Network Rail and operators are incentivised to reduce industry costs. As a franchise operator, we expect that a proportion of the benefit accrued by the franchise is passed through to the Department to reduce the cost of the industry to the taxpayer.

Therefore, in considering how the incentive that is provided by REBS will operate, it is also important to consider how efficiency savings that operators will deliver through either the REBS incentive or through Alliances will be treated by the Department.

It is not possible to consider the impact on operators in isolation without also considering the relationship operators have with the Department through the Franchise Agreement, and what form the mechanism the Department will also seek to introduce to ensure an appropriate upside share. At the current time the form of such a mechanism is not visible and whether a common mechanism will be sought for all franchises.

***Summary***

In summary, we are firmly of the opinion that REBS cannot be treated in isolation to wider industry initiatives including the final CP5 settlement and future Franchise Agreement provisions. At the current time there is insufficient visibility or confirmed detail of other critical elements, consequently it would be inappropriate to make firm decisions at this stage. There is the risk that REBS becomes a fixed solution against a moving base.

We however are firmly of the opinion that minority operators or any operator outside a deep alliance should not be exposed to downside risk.

We have to date demonstrated our engagement with the debate and dialogue concerning REBS and the wider industry questions and we will continue to engage constructively and positively as this process moves forward. We support the underlying principles behind REBS but believe that further analysis is required before firm decisions regarding the final form can be taken.

If you would like to discuss any of the points raised in this response in further detail, please contact me at the address above, by e mail [richard.stuart@go-ahead.com](mailto:richard.stuart@go-ahead.com) or by phone on 07970 045601.

Yours sincerely

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