Department for Transport

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Jonathan Hulme
Office of Rail Regulation

Sent by email to:
jonathan.hulme@orr.gsi.gov.uk

Dear Jonathan,

This letter is the Department for Transport's response to the Office of Rail Regulation's periodic review 2013 further consultation on aligning incentives to improve efficiency, published on 3 May 2012. The points covered in our response have already been the subject of constructive discussions between us, and we look forward to further such discussions as proposals are developed.

The Government's Command Paper – *Reforming our Railways: Putting the Customer First* – set out its view that better aligning incentives is essential if the railway is to produce better outcomes for passengers and freight, and in the most cost-effective way possible.

Aligning incentives fits with better regulation principles by giving train operators and Network Rail the incentives to pursue efficiencies without delivery being micro-managed by central Government.

Chapter 2 - Re-cap on the Regional Efficiency Benefit Share (REBS)

The Department supports the Office of Rail Regulation's (ORR) proposals to expose train operators to out- and under-performance against Network Rail's Operations, Maintenance and Renewals (OMR) efficiency target within a control period, through the proposed Regional Efficiency Benefit Share mechanism.

It will be important for the ORR to resolve outstanding issues with this mechanism, such as over the measurement of efficiencies and its interaction with alliancing (see response to chapter 3), in order to avoid uncertainty and maximise franchise value. There is a question as to whether the ORR should offer opt-outs to minority operators in a Network Rail route area, in particular where these operators are exposed to risk with limited opportunity to influence Network Rail costs (or influence an alliance's baseline, in the event that REBS payments are made after alliancing).

The Department supports the ORR's principle of a challenging but outperformable efficiency target.

Chapter 3 - REBS and alliancing

The Department supports the ORR's view of REBS as a default incentive exposing train operators to Network Rail's OMR expenditure target.

To incentivise operators beyond REBS, the Department supports the introduction of bespoke partnership working arrangements on the network, where such arrangements, or 'alliances', can be shown to be of benefit to farepayers and taxpayers, and are consistent with the existing regulatory and legal framework, notably with regard to the protection of access rights and non-discrimination for other operators.

A helpful workshop was convened by Network Rail recently specifically on the interaction between alliancing and REBS. Without prejudice to the various views expressed on the REBS mechanism itself, the workshop appeared to establish broad support for the REBS calculation to be made after alliancing (i.e. the ORR's option B), on the basis that this would ensure the right industry behaviours both within and outside of alliances.

The Department's initial view would be to agree that the ORR's Option B is the right one, though we will be interested to note further views emerging from this consultation.

Chapter 4 - Exposing operators to changes in Network Rail's costs at a periodic review

The Department shares the ORR's objective of partially exposing franchised train operators to changes in Network Rail's costs at a periodic review.

However, as the ORR's subsequent letter of 1 June set out, the Department believes that there are significant risks over the level of complexity inherent in the specific mechanism proposed by the ORR's consultation, and over value for money for the taxpayer.

Following further engagement on this subject with ORR officials, the Department's view is that the same goal of exposing operators to changes in Network Rail's costs at periodic review might be achieved without the need for a new regulatory mechanism.

The Department is therefore considering the scope, in new franchises, to remove franchised train operators' protections from at least a portion of <u>cost-related</u> changes in:

- the variable usage charge; and
- possibly, after further work, the variable elements of the fixed track access charge.

The Department recognises that it is unlikely to be appropriate to expose train operators to <u>structural</u> changes in charges (such as a shift between the level of Network Grant and subsidy for passenger services) that do not arise out real-world cost changes, and would propose to continue offering train operators protection for these elements through the franchise adjustment mechanism (schedule 9 of the Franchise Agreement).

A further area for consideration is the case for exposing operators to cost-related changes in schedules 4 and 8 – the possessions and delay incentive mechanisms in track access agreements – and to the capacity charge. Again, the Department recognises that protection is still likely to be needed for structural changes.

The Department recognises that further discussion is needed on these principles with franchised train operators and potentially other stakeholders, and would propose to do so as part of future franchise competitions.

Clarity and transparency over proposed changes

As outlined in the Command Paper, the Department is strongly of the view that whole-industry financial transparency will support efficiency initiatives, including alliances between track and train, and encourage challenge where appropriate. Underpinning any proposed changes, therefore, should be a clear expectation of transparency and prescribed methodology. The Department supports in particular the ORR's proposals, on page 20 of the consultation, for Network Rail, including information relating to alliances in its regulatory accounts.

Regionally distinct access charging and its application to the freight industry

Although not specifically a subject of the ORR's consultation, the Department would also like to mention geographically distinct access charges. The Department supports the ORR's moves towards these charges, and considers this to be an important feature of creating better alignment between Network Rail and train operators at the local level. It is crucial in developing any system, however, that there is no material addition to regulatory burden – this might for instance be helped by providing a "one stop shop" front end for operators covering multiple NR routes.

There are a range of particular considerations for the freight industry, given the national nature of operations, competition with the road haulage sector, and the need certain types of freight have for short-notice paths with relative certainty over price. As a result, the Department considers that the case for moving freight to regionally distinct access charging is not yet made, and that more work is needed to assess the relative benefits compared to a simple national pricing structure. This would also need to consider the possible responses to differential access charges in terms of routing, and whether those were or were not desirable for the overall network.

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