ARRIVA

Arriva's comments on PR13 Volume Incentive consultation, December 2012

These comments are made on behalf of Arriva plc, its subsidiary Arriva UK Trains Limited and its wholly owned train operating companies, Arriva Trains Wales/Trenau Arriva Cymru Limited (ATW), DB Regio Tyne & Wear Limited (DBTW), The Chiltern Railway Company Limited (CR), Grand Central Railway Company Limited (GC) and XC Trains Limited (XC). Arriva is a wholly owned subsidiary of Deutsche Bahn AG (DB AG).

Q.1.Do you recognise the importance of efficient management of network capacity in driving improvements in value for money from the rail network? Do you recognise the role played by the Volume Incentive, if effective, in driving behaviours which contribute to more efficient capacity management? Is there more that we could be doing, through the Volume Incentive or otherwise, to improve the development of information which would help to improve efficient capacity management and to inform the system operator?

We consider the volume incentive can potentially fulfil a major role in improving efficient provision of train services through the incentivisation of Network Rail (NR). We consider it should be based on three elements:

1. In most industries a supplier would be incentivised to produce more of what its customers want and will pay for, as supplying more output will improve its financial performance and long term viability. NR is a monopoly supplier, its finances are reset every five years and its payment for expansion of output takes the form of Variable Track Access Charges (VTAC), which as they are set at short run marginal costs means no financial benefit is achieved from expansion.
2. NR is strongly incentivised on performance, which, given the financial indifference to output at the margin, means it is actually incentivised to reduce output. The volume incentive needs to counteract this effect.
3. Rail services, both passenger and freight, provide economic and social benefits external to the rail industry. It is appropriate that Government recognises these benefits and provides incentives to deliver them.

Q.2. Do you recognise the important potential role of charges in providing information on costs and the uses of revenues and subsidy and in sending better signals for efficient provision and use of network capacity? Do you have any comments on the proposed scope, and timing, of the longer-term work programme to develop charges as outlined above?

Charges may have a wider role in providing information to assist efficient provision and use of the network. It must be recognised that there are significant practical problems arising from the high proportion of joint and common costs, allocation of overheads and establishing prime purpose which may limit the capability of access charges to give nuanced signals between types of service or services in different parts of the network. We believe the first priority is to address the overall incentivisation of NR and establish behaviours which are based on supporting train operators in meeting their business objectives. Increasing the VTAC by addition of a suitable profit margin would be a simple step towards a more normal commercial structure. This would be a step towards the more normal relationship mentioned in the 1st element we list in response to Q1. As Government sets the financial architecture of the rail industry and represents the interests of the wider economy, we consider it entirely correct that Government funds the 2nd and 3rd elements we describe of the volume incentive direct to NR.

Q.3. Do you have any specific experiences of the effectiveness of the current Volume Incentive which it would be helpful to share? Can you provide specific examples of where the incentive does appear to have worked and where it has not? Why exactly do you think that the incentive is not fully effective at present?

Our view is that the Volume Incentive is almost totally ineffective at achieving its purpose, for a number of reasons:

- few people at NR understand the volume incentive
- it is paid in arrears and accounted for centrally so it does not feature in the thinking of managers who may be in a position to expand and optimise use of capacity
- the volume incentive accrued does not feature within management incentive plans
- pressures on performance and completion of works to time have a much stronger effect on relevant managers.

We are not aware of any examples where the volume incentive has worked. However, on a number of occasions, for example our applications for access rights for GC on East Coast and additional XC services, we have found NR reluctant to agree to additional services and unwilling to make use of its flexing rights to accommodate them, even when evidence of a solution is provided to NR.

As indicated in our responses to Q1 and Q2, we consider only one of the three elements of the volume incentive could be appropriate as a charge on train operators and the other two are a proper charge on Government. Therefore, at least in the near future, we consider the entire incentive should be paid by Government.

Q.4. Do you agree with the range of design features which we have chosen to consider with the aim of improving the effectiveness of the incentive? Are there other changes you think we should consider making? If so, how would these changes improve the effectiveness of the incentive? Do you think that possible changes to the design and levels of the Volume Incentive have the potential to improve its effectiveness?

We consider that alterations to the design of the volume incentive are significantly less important to improving its effectiveness than changing its use within NR to encourage greater alignment with the incentive effect intended. This might take the form of applying part of the volume incentive to the Management Incentive Plan and devolving part of it to NR Routes. NR should also be encouraged to consider how common functions, such as the Milton Keynes train planning function, can be aligned better with the desire to increase efficient use of the network. Increasing the level of the incentive and developing a numerate understanding of the three elements listed in response to Q1 would be of value.

Q.5. Do you have views on what would be involved in calculating the actual incentive rates at a route level to a sufficient degree of robustness? Are alternative approaches to calculating route level incentives available? Are route level incentive rates likely to increase the complexity of the incentive beyond their benefits?

An element of disaggregation to route level would be of value in increasing understanding and creating more common interest between route managements and those of train operators. It would also be of value in creating a balance of incentives with the strong pressure on routes over performance (element 2 in Q1). However, routes are not homogeneous, indeed most deliberately combine a heavily used and high earning trunk route into London with a network of other lines. As such any volume incentive calculated by route would be only marginally more reflective of the local impact of each potential increase in service than a national figure. Given the difficulties of producing a route-based figure we consider it not worthwhile and would favour option 2, a national figure disaggregated at least partly in line with local growth.

Q.6. Do you agree that disaggregating the incentive to an operating route level by measuring actual volume relative to route based baselines is the most sensible and practical refinement to the existing Volume Incentive and that it could improve its effectiveness? What alternative approaches might exist which facilitate the calculation of route level incentive rates – and would these be sufficiently representative to drive differing behaviour according to value?

We agree that Option 2 is much more practical than Option 3. If the route-based baseline is set at a floor a few per cent below the base figure it would avoid the perverse outcome suggested and also avoid, other than in very extreme circumstances, the loss of incentivisation that results if there is an initial reduction in volume in a control period, but would protect NR from substantial down-side risk.

Q.7. Do you think that alternative ways of disaggregating the incentive for example by Train Operating Company are attractive? What do you think what be the impact of this on the incentive properties of the Volume Incentive? How would freight and open access operators be affected by TOC (or indeed) route level disaggregation given that they often span multiple routes but not in the same way as TOCs?

We do not see these as priorities. It would be much more complex, but most TOCs and FOCs incorporate a range of services over lines with differing traffic levels, so that little gain would be made in accurately incentivising economic efficiency.

Q.8. Do you agree that, in principle, a downside could improve Network Rail's responsiveness to unexpected demand for the use of network capacity and improve its overall incentives, and ability, to improve efficiency in capacity management? Do you have views on the possible design of the downside mechanism?

We believe that introduction of down-side risk would be valuable, firstly, as a counter-balance to the unfortunate tendency to seek performance gains by reducing use of the network and, secondly, to avoid loss of incentivisation if there is any dip below the benchmark figure. However, NR has high levels of fixed costs, so a 'floor' would seem appropriate, say at 5% below benchmark.

Q.9. Do you agree that we should continue to apply the Volume Incentive to all routes regardless of whether it is a 'congested' route?

Yes. Although in principle the idea of NR being more incentivised to increase volume where there is greatest need is attractive, we consider the measurement and designation of congested routes to lack the necessary robustness to form the basis of charge adjustments.

We believe the incentives on TOCs and FOCs to grow the parts of their business with greatest value means that they will put their efforts into proposing solutions, so a national volume incentive regime with some disaggregation to NR routes is sufficient.

Q.10. Do you agree that we should continue to exclude ESI coal and spent nuclear fuel freight from the Volume Incentive? Should this still be done if the incentive is calculated at the route level?

We understand the economic logic of disregarding ESI coal and spent nuclear fuel freight from the volume incentive. However, if as suggested, there are difficulties in obtaining the necessary data for exclusion, we do not think the distortion of including them would be great.

Q.11. Do you agree that we should continue to allow Network Rail to benefit from all growth regardless of how it has arisen?

Yes. We would actually see it as of value that NR is incentivised to cooperate and find solutions to third party rail development projects.

Q.12. Do you agree that we should continue with the present payment mechanism but promote its annual accounting at route level? You are invited to put forward alternative or additional proposals to improve the understanding of, and engagement with, the incentive, both in relation to how it is paid and accounted for and any other governance features.

As the Government makes the payment we do not see that the fact that it is paid five-yearly in arrears is an obstacle to its potential to incentivise on a year-by-year basis. Providing the mechanism can be calculated each year, the correct accounting treatment is to accrue on the basis used now. NR should be required to apply a certain amount from this each year to its management incentive plan and encouraged to identify a significant proportion to route level.

Q.13. Do you agree that we continue to use broadly the existing approach to calculating incentive rates? What other approaches might be available and how would they improve the effectiveness of the Volume Incentive relative to the existing approach?

We broadly support continuation of the existing approach to calculating rates. However, we note that this value based approach does not include any element to counter-balance the other incentives on NR to favour performance over volume and suggest consideration is given to evaluating a top-up to reflect this.

Q.14. Do you expect that the passenger incentive rates that we have proposed would drive significantly better capacity management on Network Rail's part? If not, please explain what level of rates would be needed to be effective in changing Network Rail's behaviour and why? We are interested in your view on an alternative higher rate proposal set out in Annex C.

We support the rates proposed. Our view is that the immediate priority for CP5 is to address the issues of disaggregation to routes, incentivisation through NR's management incentive plan, greater transparency and briefing as, without these measures, even if the incentive rates were dramatically increased, we doubt if behaviours would be changed.

Once these priorities are addressed, there may be a case for moving to higher rates as suggested in Annex C, but we would suggest such an increment be ring-fenced to a volume growth fund, under joint industry governance, able to fund infrastructure or other measures that would enable the growth to be achieved.

Q.15. Do you expect that the freight incentive rates that we have proposed would drive significantly better capacity management on Network Rail's part? If not, please explain what level of rates would be needed to be effective in changing Network Rail's behaviour and why? Do you consider that freight rates should be adjusted on the grounds that a difference between passenger and freight rates has the potential for a distortionary incentive effect?

We support the rates proposed. Our view is that the immediate priority for CP5 is to address the issues of disaggregation to routes, incentivisation through NR's management incentive plan, greater transparency and briefing as, without these measures, we doubt if behaviours would be changed. We do not think the small possibility of distortion caused by the change in relative passenger and freight rates is reason to disregard the updated calculation of the freight rate.