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Dear Cathryn

Network Rail's Response to ORR's Volume Incentive – Transmission Mechanism

1. I am writing in response to your letter of 4 April on the transmission mechanism for the Volume Incentive in CP5. It is helpful that you have raised these issues.
2. As your letter notes we set out our views on the Volume Incentive in our response to your December 2012 consultation. This response covered some of the issues in your recent letter. However, we welcome the opportunity to provide further clarity on transmission mechanisms for the Volume Incentive for CP5.
3. As stated in our consultation, Network Rail considers that the Volume Incentive can play a vital part in encouraging our staff to seek to accommodate additional trains onto the network. Because our variable charges are designed to be cost recovering, absent such a mechanism Network Rail would be 'financially neutral' as to the level of trains that operate on the GB network. The Volume Incentive helps address this issue by providing a financial reward for accommodating additional trains on the network, over and above the ORR-determined baseline.
4. The industry has a shared aim to make best use of the GB rail infrastructure to generate maximum value for the country. The Volume Incentive helps achieve this.
5. Network Rail's stated purpose is to "*generate outstanding value for taxpayers and customers*". Consistent with this, the Volume Incentive creates a financial benefit if the company increases utilisation of the network. It can also provide an important balance to the high-profile incentive to meet our performance targets, which could otherwise 'trump' any desire to squeeze more trains onto our busy network.

Background

6. As stated in our consultation response, we strongly support ORR determining the Volume Incentive baseline at a national level. However, we also recognise the importance of being very clear about how the national baseline translates into each of the Operating Routes own targets so that this can become a key part of how we measure success at route level.

7. We consider that Network Rail, in consultation with our train operating customers, is best placed to disaggregate a national incentive into route baselines for CP5. We have proposed that we would do this by way of a consultation process shortly after ORR publishes its Final Determination.
8. We consider that, consistent with Network Rail devolution, this approach would make each route's contribution to the national volume target explicit. This would increase the effectiveness of the Volume Incentive by disaggregating the traffic growth forecasts to the level that many decisions are made, i.e. by operating route.
9. We note that respondents to the consultation have stated that a transparent and powerful transmission mechanism would improve the Volume Incentive and seek to address this, below.

Proposed transmission mechanisms

10. We agree that ultimately it should be for Network Rail to decide how the Volume Incentive is transmitted into our decision making processes and our people's individual incentive arrangements. In our consultation response, we proposed a number of different ways in which we could do this. I provide further detail of these, below and consider that they are consistent with the illustrative measures set out in your letter. I am pleased to be able to confirm that my Executive colleagues are fully supportive of these commitments.

Inclusion in financial value added measurement: In CP4, payments from the Volume Incentive are not recognised through our annual FVA measure. We consider that, in CP5, the Volume Incentive should be included in the annual FVA measure, as was the case in CP3. This would create a direct financial link to route performance and increase the visibility of the incentive to decision makers through colleagues' bonus arrangements, which will themselves be linked to FVA. Including the Volume Incentive in FVA would have the effect of it impacting bonus arrangements for all senior Network Rail colleagues.

Disaggregation of volume incentive: We would disaggregate the volume incentive to routes and use this to measure their success within the business. Senior route-based colleagues' bonus arrangements would be affected by their route's performance against its traffic targets by way of its impact on the route's FVA. All senior colleagues working in 'central' roles would be affected by the sum of the combined routes' performance against the national traffic targets by way of their impact on group's FVA.

Strengthening the incentive: It seems self-evident that if the Volume Incentive rates were increased in CP5, the incentive for Network Rail to accommodate additional traffic would be stronger. If the overarching aim is to increase the power of the incentive, this appears to be an effective approach.

Transparency: As part of our transparency agenda we are committed to being more open with our information with the aim of stimulating debate on our work and that of the rail industry as a whole. It will be important that each route's performance against their traffic baseline should be transparent. Consistent with that, we propose publishing baseline and outturn traffic figures at a route-level in our annual Regulatory Accounts.

Use of Outperformance of the Volume Incentive Baseline

11. One of the issues that you raise in your letter is the way that any additional funds that accrue from the Volume Incentive in CP5 could be used. We discussed this recently at one of our regular PMM meetings. You will recall that in CP3 Network Rail published a set of criteria for how funds from outperformance should be treated. We committed to revisiting those criteria later this year. However, in lieu of that review, I would like to emphasise one of the points that I made at that meeting.
12. In the absence of the conventional approach of providing a risk buffer to help us deal with risks that 'crystallise' during CP5, one of the considerations for how to use any funds that accrue from a Volume Incentive will be the potential creation of a 'thin' self-generated risk buffer.
13. A 'self generated' risk buffer would be particularly attractive if ORR decides to introduce a downside component to the Volume Incentive in CP5. This would introduce additional risk to our funding if we 'spent' Volume Incentive funds accrued in the early part of CP5 only for the later part of the control period to swing into negative Volume Incentive territory.
14. A key mitigation to avoid us too readily 'spending' funds accrued from outperformance of the Volume Incentive baseline will be to make decisions at a corporate level as opposed to hypothecating outperformance at the route level. This is distinct from how we measure success which needs us to disaggregate the volume incentive to routes. By keeping decisions about how we spend outperformance at a central level we will benefit from the 'portfolio management' of our routes' performance and will be best able to smooth out 'good' and 'bad' performance, and to make best use of any investment for the network as a whole.

Outperformance fund

15. In CP3 we created an outperformance fund for investment in the network. In CP4 we have also made discretionary investment as a result of projected outperformance. The ability to reinvest outperformance is an important motivational tool for the business.
16. We propose that, where there is overall outperformance against the Volume Incentive baseline, decisions about how to use any gains would continue to be made centrally in the light of the financial position of the company and other relevant circumstances – consistent with my earlier point about potentially creating a 'self-generated' risk buffer.
17. This is essential since there are likely to be areas where the business underperforms and others where we outperform targets. Any decision about how to use outperformance would, therefore, be made at an overall level rather than differentiating the source of outperformance.
18. We consider it is important that we are clear internally on the governance arrangements for use of outperformance. We are proposing that routes would be expected to make proposals, as they currently do, about ways of spending such sums, with these being judged against appropriate 'payback' criteria. We also propose working with passenger and freight operators through existing processes, consistent with the use of other CP5 funds in determining which schemes to fund.
19. We would also be transparent about how we spend any outperformance and report this in our regulatory accounts with further detail in the annual return as appropriate.

Summary

20. We consider that the proposals discussed, above, will contribute towards significantly improving the transmission mechanism for the Volume Incentive in CP5. However, we recognise that they still require further development and we would seek to further develop them in consultation with our customers and routes prior to the start of CP5. We consider the most appropriate time to do this would be once ORR has concluded on the Volume Incentive for CP5. We would then issue an industry consultation on the customer facing issues described above – in particular the governance arrangements for determining any spend of outperformance.
21. The Volume Incentive plays a very important role in making maximum use of the GB railways. Without it Network Rail would receive no financial reward for growing traffic levels. We do not consider that the existence of the Volume Incentive reduces our output commitments to operators and other funders but it does incentivise the promotion and facilitation of incremental growth.
22. Following Network Rail's devolution to its Operating Routes, there is a much greater focus on each route's profitability, rather than just their costs. It would, therefore, be natural for us to include the Volume Incentive effects in route financial performance measures and to consider it part of how we measure success at a route level.
23. Given the importance of this mechanism, I would be very happy to meet to discuss our response to your letter, if you would find that helpful.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'PP Plummer', written over a horizontal line.

Paul Plummer