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Chair Remuneration Committee
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Network Rail's Management Incentive Plan

1. The purpose of this letter is to set out where we have got to in our discussions on Network Rail's Management Incentive Plan (MIP) in the last few months. Thank you for all your work on this.
2. Network Rail is required by its licence to have an MIP. The licence requires Network Rail to comply with the incentive policy which sets out a range of principles which the MIP must meet. The licence also gives ORR the power to set objectives for the MIP. ORR did so in March 2011. They are attached for reference to this letter as an annex ([Bill Emery's letter of 24 March 2011](#)).
3. We have had a number of discussions with you on Network Rail's MIP over the last few months in order to resolve outstanding issues in the version of the plan you presented to your members (e.g. the definition of Financial Value Added). This also gave me, as ORR's new Chief Executive, and the three recently appointed non-executive directors on the ORR Board, the chance to explore how you propose the MIP should operate.
4. These discussions have highlighted significant common ground between us:-
 - a. We both agree that Network Rail needs to be able to attract and retain staff of the right quality for the significant challenge it faces for Britain's railways. During this price control period (CP4), Network Rail is planning to deliver £11.8bn of enhancements to our railway network as well as a £17.6bn programme of maintenance and renewals, while ensuring the network continues to improve in terms of safety, performance and efficiency as set out in the CP4 targets.

- b. Both parties have distinct roles. It is for the Network Rail Board, its Remuneration Committee (Remco) and its members to decide on the level of remuneration for the company's staff, and not the regulator. For the regulator to do so would in effect mean we would be running the company. The regulator's role is to lay down the principles and objectives to guide your remuneration approach. Given Network Rail's significant public funding, remuneration needs to be commensurate not only with the need to recruit and retain talent but also with outcomes that are transparently value for money and serve the public interest. We are agreed that it is important that judgments around such the relationship between what is paid and achieved should be widely understood and acceptable. Within the framework laid down for the MIP in the licence condition and ORR's objectives, this means Remco, the Board and members have a vital role to play in looking at both the company and the wider public interest.
- c. You have said that the Network Rail Board and its Remco fully support the objectives we established in March 2011 under the licence condition which mean that the MIP must
- strongly incentivise the delivery of the CP4 outputs;
 - strongly incentivise the outperformance of the CP4 efficiency targets;
 - in doing so, reward only management effort resulting in network improvements and efficiency gains which are sustainable over time, and not windfalls;
 - achieve high levels of accountability and transparency for members funders and taxpayers, setting out a clear value for money case and taking account of ORR's annual assessment of the company's performance and of any penalties levied against the company.

5. The discussions between us over the last few months have been helpful, and have made significant progress. We welcome the changes you have subsequently made to the MIP including on the value for money case; the significant changes to establish a proper definition of Financial Value Added (FVA); establishing that in reaching its decisions Remco will take full account of ORR's annual assessment of the company's performance in delivering for railway's customers and funders; and that a catastrophic safety failure could result in no bonus award.

6. In thinking about the design of the MIP, there are two sets of issues which need consideration: the application of ORR's objectives to the proposed framework of the MIP

and then, subsequently, the application of the objectives to the annual decisions taken under the MIP. This letter focuses on the application of the objectives to the framework but also on specific issues where it needs to be clear how Remco will exercise its discretion.

7. Our discussions highlighted three areas where it would be helpful to have clarification of ORR's position.

Annual Incentive Plan

8. You have taken the view that the CP4 targets should not be a trigger to payments under the Annual Incentive Plan (AIP). We recognise that you want the AIP to incentivise improvements in a wide range of areas designed to transform the company's performance, not just the CP4 targets, and that progress on the specific CP4 targets is unlikely to be linear. We consider it important, however, that the hurdles and business goals are stretching. In this context we welcome the reference in the business goals to the improvement trajectories agreed between us on asset management and safety.

9. We also note that neither of the two hurdles you have chosen explicitly reflect CP4 targets. We therefore expect Remco, in assessing annual performance under the AIP, to take full account of ORR's assessment of the company's performance including on the CP4 targets. You have indicated that Remco will do this. ORR will continue to monitor, report on and if necessary take enforcement action against the CP4 targets across the whole period. Significant payments under the AIP would not be consistent with material underperformance by Network Rail on CP4 targets.

Gainshare Plan

10. If CP4 targets are not a trigger for rewards under the AIP, then the Gainshare Plan (GSP) cannot pay out unless the targets have been materially achieved by the end of CP4. The CP4 targets are the key performance outputs required from the company in the current control period. Again, ORR will expect Remco to take account of ORR's assessment of achievement against these targets. As with the AIP, it would not be appropriate for the GSP to pay out significant awards if the CP4 targets and programme of work that are vital to the efficiency of the railways had not been materially achieved by the end of CP4.

11. We have also had extensive discussions with you on the definition of Financial Value Added (FVA) which is a critical element in the GSP. It has been helpful in reaching resolution in this complex area that we are both agreed that the FVA figure will need to be adjusted to ensure that only management effort, sustainable network improvements and genuine efficiencies are rewarded, not windfall gains. Again, this is an area where we will look to the Remco to ensure it applies this principle and takes full account of ORR's

assessments including on efficiency gains. I think we are agreed on all this and the only outstanding thing to do, which should not be contentious, is the final check to which we are committed on the detail of the FVA measure.

Transparency and accountability objective

12. We attach considerable importance to the transparency and accountability objective we have set for you. In this context, we welcome Network Rail's decision to make its comparative benchmarking information publicly available. You have explained to us why you do not think public sector comparators are appropriate – you will need to demonstrate this to members and funders. We also welcome the information you plan to make available on the size of the overall package and the potential payments to individuals under it across the price control period so that members can fully consider it. It is for you to decide on your processes for consultation with members and funders. Our objective requires proper and effective consultation with both parties in advance both of final agreement on your framework for the MIP and on your annual decisions under it. You will also need to consider what information you make publicly available – we expect that key information about the MIP should properly be in the public domain.

13. I am placing a copy of this letter on our website and sending copies to Philip Hammond, Lin Homer and Steve Gooding at the Department for Transport, Keith Brown and David Middleton in Scotland and to Rick Haythornthwaite at Network Rail. I am also making arrangements for your members to receive copies.

With best regards,

A handwritten signature in blue ink that reads 'Richard Price'.

Richard Price

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24 March 2011

Dear Steve

High level objectives for your management incentive plan

1. I wrote to you on 3 March setting out our proposals and we are grateful for your positive response of 14 March.
2. My board reviewed the position at our meeting on 15 March. In accordance with your management incentive plan licence condition (condition 16 in part E - corporate matters - of your network licence) we have decided to establish the three high level objectives in the form we consulted on. These are:
 - (1) **Delivery objective** - that the primary focus of your framework should be to **incentivise proven long-term sustainable delivery of all of Network Rail's performance and output obligations** coupled with a requirement to give full weight to the improvement trajectories agreed between us to ensure progress on **efficiency, service culture, excellence in health & safety culture / risk control** and **asset management excellence**¹
 - (2) **Out-performance objective** - the rewards within your framework should be so proportioned that they **strongly incentivise significant out-performance** of the efficiency assumptions established at the 2008 periodic review
 - (3) **Accountability and transparency objective** - that you seek the views of your principal funders and members and do so openly and transparently:

¹ An agreed summary of the control period regulatory obligations and improvement trajectories is set out in an annex to my letter to David Higgins of 1 March 2011

- initially on your full rationale and justification for your overall framework and its potential implications for your executives' remuneration (in aggregate terms), and
 - annually on the data and information you are using for the decisions you intend to take under your management incentive plan year by year (again in aggregate terms) and
 - in both cases have regard to the information and views expressed in your published final decisions which will need to include a full explanation of your reasons and how you have dealt with the views.
3. In complying with these objectives you will need to explain to your principal funders and your members how the decisions you intend to take each year reflect the market you are in for executive talent and in particular the additional value you have created for the taxpayer and users of the railways (the wider public interest) that you are rewarding. Your proposed decisions on remuneration will also have to demonstrate how you have taken account of our assessments of your company's performance and efficiency improvement and how any underperformance has been reflected in your decisions. You will also have to set out how your proposed decisions have reflected any penalties imposed on the company by us or the courts.
4. As I noted in my earlier letter it is now for you to design your management incentive plan framework so that it aligns with the objectives and the other requirements of the licence condition. Following a submission from you setting out your plan framework (including a reasoned explanation of how it complies with the licence obligations) it will be for us to decide if that has been achieved. Of course within a framework that complies with the objectives, the setting of targets (and their justification) remains a matter for you and your board/remuneration committee colleagues overseen by your members.
5. You have told me that you are in an open and transparent dialogue with both your principal funders and your members on both your proposed plan framework and the detailed hurdles and targets together with their rationale.
6. You shared further details of your proposed plan with us last week. When you seek our confirmation as to licence compliance we shall need to see further details on the hurdles, performance goals in the annual incentive plan and the financial value added measure / trajectory in the gainshare plan. However at this stage I can confirm that I do not see any fundamental reason why we should have any difficulty in declaring your plan framework as being compliant with your licence and the three high level objectives we have set. This is of course dependent on you providing an acceptable explanation of how the plan meets the objectives.
7. I am copying this letter to Steve Gooding and Nick Bisson (Department for Transport), David Middleton (Transport Scotland) and your members (via Hazel Walker). I am also publishing this letter on our website.

Yours sincerely

A handwritten signature in blue ink, which appears to read 'Bill Emery', is positioned above the printed name.

Bill Emery