



Improving rail incentives

RDG PR18 working group on route-level regulation

16 September 2016

Today's agenda

■ **Aligning incentives in the rail industry – ORR and DfT (20 mins)**

- Introduction (role of the two organisations) – ORR
- What are we trying to achieve
- Incentives (REBS)

■ **Improving rail incentives – DfT (50 mins)**

- Incentives (alliancing)
- Incentives (variable usage charge)
- Incentives (bespoke funds)



Purpose and rationale

This presentation

■ Purpose:

- This presentation forms part of our engagement with the industry to inform our December consultation on charges and incentives.
- To share our ideas on how industry incentives could be better aligned.
- To encourage industry views and discussion about this policy area.

■ This slide pack is structured as follows:

- Background
- Aligning incentives – summary of different approaches
- Roles of ORR and DfT
- Aligning incentives – high level ideas for REBS
- Next steps

Rationale of this policy work

- As part of our work on the 2018 periodic review (PR18), we are reviewing the current structure of charges and incentive mechanisms. The latter includes a review of the Route-level Efficiency Benefit Sharing (REBS) mechanism.
- The aim is to consider ways of strengthening the alignment of incentives on Network Rail and train operators to work together to improve cost efficiency.
- This has close links with our PR18 high level outcomes. In particular, **a more efficient network** through:
 - greater engagement between (franchised) operators and Network Rail to reduce its costs – **Network Rail efficiency**
 - improved operators' understanding of the costs they impose on the network – **operators' efficiency**.

Aligning industry incentives

- Together with the DfT we have identified the following mechanisms to help align industry incentives.
- We do not view these as mutually exclusive.

Between control period exposure mechanisms

- Track access charges
- Exposure to VUC
- Exposure to some elements of fixed charge

In control period exposure mechanism

- e.g. REBS

Alliances

- Alliances that expose operators to Network Rail's costs

Bespoke funds

- Designed to improve infrastructure efficiencies

Roles of ORR and DfT

ORR and DfT are discussing this policy area with respect to DfT-franchised operators, and developing possible policies for CP6 and beyond

Roles of ORR and DfT for approaches to align industry incentives

Mechanism	ORR – through track access contract, applying potentially to all operators	DfT – through franchise agreement, applying to DfT-franchised operators only
Track access charges	Creates framework for cost-reflective charges and approves individual charges	Franchised operators are largely protected from changes in charges: by DfT removing part of the protection for future franchises, TOCs become exposed to Network Rail's charges at each periodic review
Contractual mechanisms	e.g. REBS sets out arrangements for cost sharing	DfT can decide whether to expose franchised operators to REBS and any other possible track access contract incentive mechanism
Alliancing	ORR would need to approve arrangements	Franchise Agreements
Bespoke funds	Subject to funders' requirements, in Network Rail funding settlement	Franchise Agreements

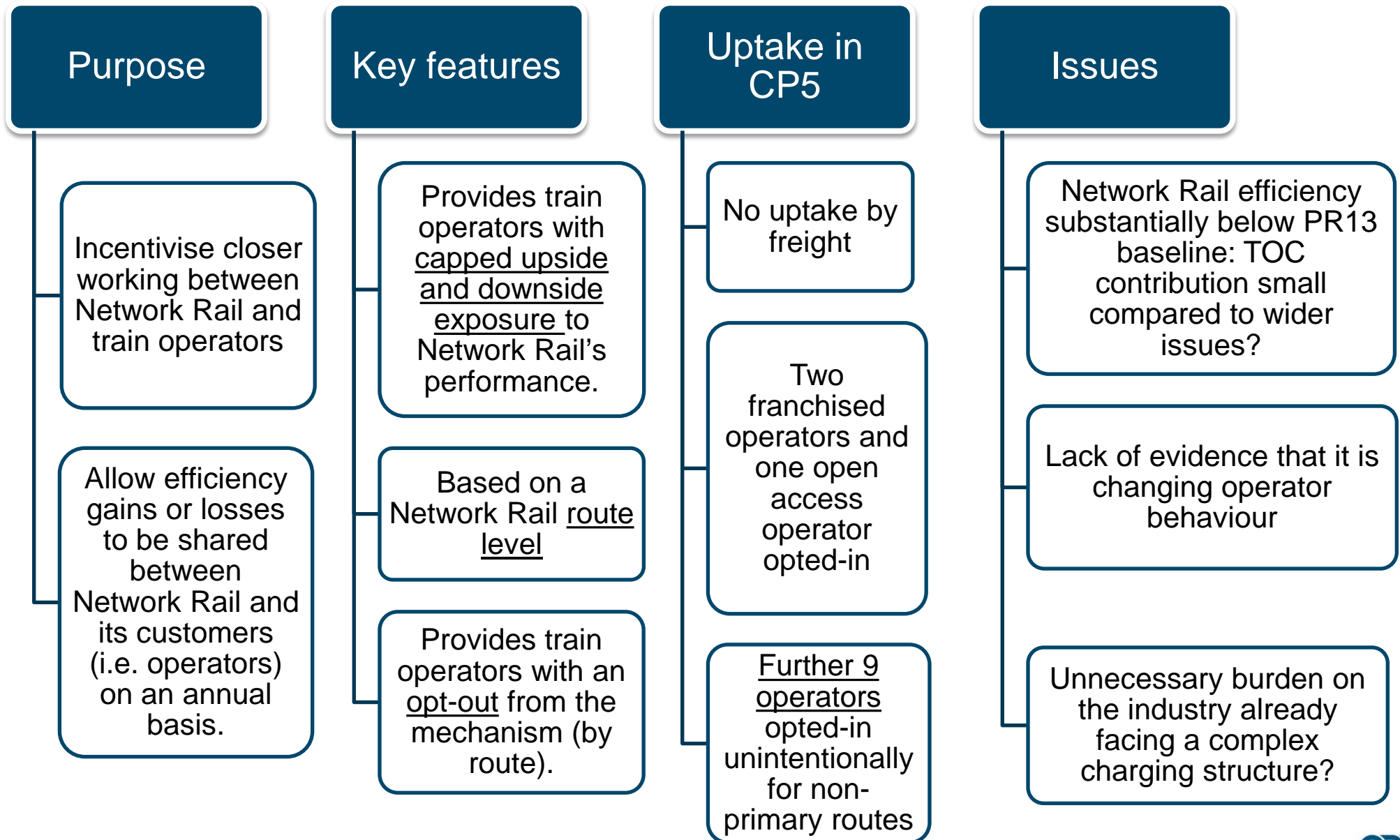


OFFICE OF RAIL AND ROAD



Aligning incentives – developing options for REBS

REBS – the CP5 mechanism



REBS – what options should we consider in our December consultation?

A: Removing REBS.

B: Changing the design of REBS:

- i) resetting baselines;
- ii) changing the sharing %s;
- iii) changing the scope of expenditure costs covered by REBS.

C: Removing the optionality of REBS.

A: removing REBS

- Rationale for removing REBS: to remove the unnecessary burden of dedicating industry resources to an ineffective incentive scheme
- The problem of misaligned incentives in the rail industry would remain. So the need for an alternative – what would that look like?

B: changing the design of REBS (1)

■ i) Resetting baselines:

- **Status quo:** current REBS mechanism sets route-level expenditure baselines for the duration of a control period. CP5 baselines were set by Network Rail consistent with our PR13 final determination.
- Is this the key area that has undermined effectiveness of REBS?
- **Alternative:** reset baseline for TOCs at start of franchise, and for freight/open access operators on a more frequent basis than every 5 years.

■ ii) Changing the sharing %s:

- **Status quo:** current REBS mechanism provides operators with a 25% share upside and 10% share downside exposure to Network Rails cumulative financial performance.
- Are these share %s not significant enough to incentivise operators?
- **Alternative:** increase share %s to increase financial incentives for operators.

B: changing the design of REBS (2)

- iii) Changing the scope of expenditure costs covered by REBS :
 - **Status quo:** current REBS mechanism covers a large subset of Network Rail's costs but not enhancements and is subject to adjustments for non-delivery of output.
 - Is the scope of REBS too wide?
 - **Alternative:** a narrower scope of costs that operators could influence.

Idea C: removing the optionality of REBS

- **Status quo:** under the track access contract , operators can chose whether to opt-in to REBS or not. Only a small number of operators have chosen to participate in REBS in CP5.

- Has this undermined the effectiveness of REBS?

- **Alternative:** there are two potential approaches:
 - less radical: make REBS (or an alternative mechanism) compulsory for operators who have a primary route
 - more radical: make REBS (or an alternative mechanism) compulsory for all operators

Next steps

