

Gian Carlo Scarsi
Head of Regulatory Economics
Office of Rail Regulation
One Kemble Street
London
WC2B 4AN

Your ref:

Our ref:
NRS11-069

Date: 14 October
2011

By email
GianCarlo.Scarsi@orr.gsi.gov.uk

Dear Gian Carlo

Establishing Network Rail's efficient expenditure

Thank you for the opportunity to respond to the consultation on establishing Network Rail's efficient expenditure for Control Period 5. My response begins by offering some general points on the main issues raised in the consultation, before moving onto some more specific comments.

General points

The Scottish Ministers remain committed to investing in rail, both in terms of the day to day operation of services and expanding the capacity and capability of the network, such as the Edinburgh to Glasgow Improvements Programme and Borders project.

The considerable pressures on public finances in Scotland are well known and our rail programme is not immune to this. It is therefore critical that the ORR is able to assure the Scottish Ministers, rail users and the taxpayer through PR13 that Network Rail can deliver the management of and investment in the network in Scotland in a way which fully supports a lower-cost railway and which maximises value for money.

As with all of its functions, I would expect the ORR to undertake this assessment in full compliance with the principles of better regulation. In particular, while mindful of commercial sensitivities, the data and analysis on which the ORR's determinations are based should be available, transparent and easy to understand as should the processes through which the ORR reaches its conclusions.

In general, I am broadly supportive of the ORR's approach to establishing Network Rail's efficient expenditure. In particular, I welcome the greater emphasis on a more detailed, route based bottom up approach, which should give a much clearer indication of the key cost drivers on the Scottish operating route. I would welcome a discussion with the ORR on how it plans to undertake this assessment, in particular how it intends to disaggregate centralised costs. Intuitively, a pro rata based application of GB level assumptions would not appear to be sufficiently robust in all cases to fully capture the dynamics of the different routes.

I would expect that in delivering its outputs on Control Period 5, Network Rail will operate at a level of efficiency which is comparable to the leading rail operators in Europe and leading utilities companies in GB. In this respect, the top down, econometric approach will be of value in terms of moving Network Rail as a whole towards its goal of leading edge efficiency.

However, the econometric approach as described in the document does not appear to lend itself well to a route based assessment of efficiency, particularly the work done using international comparisons. A specific question in your consultation on objectives was around the establishment of a Scottish specific efficiency target: the answer to this would appear at least in part to depend on the robustness and comparability of route-based econometric assessment, and I would welcome further discussions with the ORR on this issue. In particular, the value of placing a greater emphasis on comparing the Scottish operating route with other Network Rail routes and with Scottish based utilities, such as Scottish Water.

In line with your expectations of greater efficiency and route based assessment, it would be useful if the ORR as part of its assessment could provide details of the specific areas in which increased Network Rail efficiency is anticipated, how Network Rail intends to achieve this, and what level of efficiency in these individual areas is expected. In addition, I should be grateful if you would confirm whether or not the efficiency gap analysis will be undertaken at a route level or on a GB wide basis.

Specific points

Support and operations

The consultation document mentions that support and operations costs will be assessed on a base year rolled forward with application of an efficiency assumption. I would welcome your views on the risks associated with this approach, in particular the degree of certainty that the base year will fully reflect the position for the duration of Control Period 5 and how you intend to smooth out any spikes and troughs in the base year expenditure.

Maintenance and renewal

The planned approach to establishing efficient expenditure in maintenance and renewal is based on Network Rail's asset management capability as reflected in their approach to asset policies and data management. I understand that these will continue to have effect on a network wide basis and I would value the ORR's view on any risk this presents given the greater focus in PR13 on route based assessments.

In PR08 and in the early stages of CP4, Transport Scotland found it challenging to engage with the ORR in terms of gaining a greater understanding of Network Rail's asset policies. As a result, our ability to offer a view to the ORR on the effectiveness of the policies with respect to the network in Scotland was limited. Clearly a repeat of this in PR13 would not be in anyone's best interests, particularly in an environment where we are moving towards a much more distinct Scottish railway. Therefore I would seek an assurance that we will have a much greater opportunity to engage with the ORR on this issue. This should be supported by a detailed assessment from the ORR of Network Rail's asset policies as they affect the network in Scotland and an assurance from the ORR that they are fit for purpose in this respect.

The issues with Network Rail's asset data are well documented, and the NAO report 'Regulating Network Rail's Efficiency' ⁽¹⁾ indicated that good information is as critical to reducing costs as financial incentives. I note that Network Rail has developed a strategy to improve asset

¹ 'Office of Rail Regulation Regulating Network Rail's Efficiency', National Audit Office, 1 April 2011.

information over Control Periods 5 and 6 – as outlined in the recently published Initial Industry Plan for Scotland⁽²⁾ - which it is of the view will deliver significant efficiency benefits. We will consider this in due course: however we would require an absolute assurance from the ORR that Network Rail's data for the Scottish operating route is reliable and robust for PR13, particularly given the emphasis on the bottom up approach to assessing costs.

There has been issue in Control Period 4 so far with what constitutes actual efficiency. In particular uncertainty over the definition of the financial value added. In addition the effects of the deferral of renewal works has been unclear. I would seek assurances from the ORR that there will be no repeats of this in Control Period 5, and that the Final Determination will provide absolute clarification on these issues.

Enhancement

The consultation document suggests that significantly greater efficiency could be achieved with respect to pre-construction and other indirect costs such as project management. I note that you intend to do further work on this and would be grateful for detailed further information on how you plan to undertake this with respect to the Scottish operating route.

I would be of the view that it would be useful to have a more detailed discussion on the issues raised in my response. I note that we are scheduled to meet with your colleagues in early November, and perhaps this would present a useful opportunity to do so.

I hope you find the above helpful.

Yours sincerely



Frances Duffy
Director, Rail

² 'Initial Industry Plan Scotland – Proposals for Control Period 5 and Beyond', Planning Oversight Group, 29 September 2011.