Appendix – Consultation Question Responses

Q3.1: Do you agree that in PR13 we should focus on incentivising delivery of outcomes that customers, wider society and funders value?

We agree that outcomes which customers, funders, and society value should play a part in defining the context for the periodic review. The review itself should focus much more sharply and clearly on Network Rail efficiency and the interface between Network Rail and its customers and the delivery of the HLOS specifications within the SoFAs. In doing this the ORR should ensure that those who are affected by the funders' specification are treated equitably.

An excessive focus on outcomes, rather than Network Rail outputs has the potential to send misleading messages to Network Rail about its role in the delivery of outcomes and more particularly industry efficiency and value for money.

Q3.2: Do you agree with our assessment of the outcomes that customers and society value?

Yes, to the extent that they have been applied to Network Rail's role; however the wider industry trade-offs have been ignored. These trade-offs are material to the industry's costs.

Q3.3: How do you see the trade-offs between and within the interests of customers, funders and society? How do you see the trade-offs between current and future customers, funders and society?

The trade-offs around timetabling are well described in Figure 3.4 of the document. Societal benefits are derived by attracting passengers to the railway from less socially beneficial modes, initially this is achieved through the attractiveness of the timetable, but sustained through the delivery of satisfactory performance. At an operational level the trade-off between planned speed and frequency of trains and performance; this requires a decision about what represents "good-enough" performance for a given market, which in turn is a function of the cost of performance, the cost of a less attractive timetable and overall affordability.

Figure 3.4 ignores the other industry trade-offs which affect its overall cost and affordability, those costs include the cost of operating and renewing rolling-stock and providing customer service including information. We would expect these trade-offs to be set out in the funders HLOSs & SoFAs.

The trade-offs between current and future customers, funders and society are an issue for government as principal funder of the railway and to some extent the ORR despite its role as safety regulator for the industry. The consideration of trade-offs also need to recognise the impact of EU legislation and technical standards, which are outside the direct control of the government of industry, but has trans-generational effects.

Q3.4: To what extent do you think we should measure and monitor the delivery of those outcomes and outputs we incentivise? What metrics should we use? To what extent is it practical and desirable to monitor delivery of outcomes at the local level?

Network Rail's major contribution to customer satisfaction comes from its contribution towards delivering a reliable timetable so it should continue to be monitored and incentivised to do this. Whilst PPM has its shortcomings as a measure we believe that it has the advantages of being well understood and having a long series of data backing it up. You might also consider monitoring right time delivery. PPM can be disaggregated to route level.

We do not support Network Rail being incentivised through the NPS score. Whilst operational performance tends to influence responses to all measures of satisfaction it is only a small element of the NPS questionnaire itself, Network Rail has very little ability to affect any other element of the survey.

If Network Rail were to be measured on other outcomes its natural response would be to try and influence or, worse, dictate them. NPS works reasonably well as an indicator for a route overall, but is poor for detailed decision making.

Q3.5: What do you see as the key enablers for Network Rail's successful delivery of outcomes in CP5? How should we best measure Network Rail's performance against these enablers? How should we best incentivise these?

We believe that you should focus on providing clear incentives for the delivery of efficient outputs. The specification of outcomes is a matter for the railway's principal funder.

Q3.6: What do you see as the key features of the transmission mechanism? How do Network Rail's customers respond to changes in Network Rail's behaviour and how does this translate into the experience of end-customers and society? How should we take this into account in the design and implementation of our incentives?

The current transmission mechanism for incentives is imperfect, for example Schedule 4 is centrally administered and separate from those who plan and undertake engineering work. This clearly dilutes its effect.

The discussion of the relative incentive effects of whether Network Rail's funding "balancing item" should largely consist of network grant or fixed track access charge overlooks the point that neither funders nor train operators can currently withhold payment of either. Network Rail has an automatic entitlement to this source of funds; consequently it has no incentive effect whatsoever. Some consideration should be given to attaching meaningful incentives to Network Rail's single largest source of funds.

Q3.7: How do you think industry reform would affect the transmission mechanism? How do you think changes to franchise agreements would affect the transmission mechanism?

Network Rail devolution should improve the transmission mechanism, provided there is meaningful devolution of control over income, expenditure and performance regimes. Closer working relationships with TOCs should also bring sharper focus on the effectiveness of the mechanisms and incentives.

Without practical experience of franchise reform it is difficult to comment, particularly as DfT is adopting a "horses for courses" approach, which indicates that some future franchises may still be quite tightly specified where funders' objectives dictate.

Q4.1: What are your views on our proposed principles for efficiency sharing arrangements between Network Rail and train operators? To what extent to do you think they will improve the incentives on train operators to work with Network Rail to reduce its costs?

It is our view that risks should sit with those best placed to manage them. Whilst closer working between Network Rail and operators should lead to outperformance of efficiency targets it is hard to think of an example where this will lead to a reduction in efficiency. We therefore question the logic behind the proposal for TOCs to share in the risk of Network Rail's underperformance, we further question the value of this part of the mechanism as it will both dilute the incentives on Network Rail to achieve its baseline efficiency target and add to the costs of franchising through increasing the level of risk to which franchisees are exposed.

Q4.2: What are your views on our proposed design of a route-based efficiency sharing mechanism, as described in chapter 4 and in Annex B? To what extent to do you think they will improve the incentives on train operators to work with Network Rail to reduce its costs?

There is little data on the relative efficiency of individual Network Rail or the relative efficiency of sole user and multi-user routes. This data is necessary to constructing incentives which link Network rail and TOC finances.

We do not understand why train operators would be expected to share in downside risk; Network Rail's downside risks are outside of TOCs control and sharing of downside reduces the efficiency incentive on Network Rail. No party should be exposed to risks they cannot control.

An incentive mechanism which allows TOCs to share in efficiency which they have actively helped to deliver provides an appropriate incentive and the means of distribution proposed in Annex B on multi-operator routes seems fair.

Q4.3: What are your views on our assessment of the role of bespoke arrangements? In what circumstances do you think bespoke arrangements are likely? What advantages and disadvantages might they bring? How should we best assess them? What are your views on the scope for excluding some of Network Rail's costs from the default efficiency sharing mechanism?

Bespoke arrangements allow for focused joint working to deliver efficiency and bespoke rewards should more closely align incentives between Network Rail and train operators. The disadvantage is that operators excluded from a bespoke arrangement will not be incentivised to the same extent.

Q4.4: What are your views on our assessment of potential impacts of a route-based efficiency sharing mechanism, as described in chapter 4 and in Annex B?

Q4.5: What are your views on our preliminary proposal for exposing passenger and freight operators to changes in Network Rail's fixed costs in subsequent periodic reviews?

There have been significant fluctuations in variable charges and several changes in methodology of calculation over the 4 periodic reviews concluded so far and there are still gaps in the industry's knowledge about how assets interact and behave over time, for these reasons we believe that exposure to Network Rail's fixed costs would produce risks for train operators and that this would increase the costs of franchising. We also question the extent to which operators are actually able to influence Network Rail's costs and therefore the extent to which they should be exposed to the Network Rail's cost risks.

Q5.1: Do you think that the current possessions and performance regime broadly help to align incentives between operators and Network Rail in the best interest of customers, funders and society? If not, why not?

The regimes do not work in isolation and are only a single element of the package of incentives which operate on both Network Rail and train operators; however the incentives provided by the regimes operate consistently with the interests of customers, funders & society. The transmission of the price signals through Network Rail is the major obstacle to their effective operation.

Network Rail clearly believes that its performance on train service delivery and engineering access is reflected in the level of underperformance and restriction of access that is purchased through the periodic review, through the setting of its performance benchmark and the level of track access supplement.

Whilst we understand the incentive effect that the access charge supplement is meant to provide, it also represents a means of subsidising inefficient possession booking.

Q5.2: Do you think it is appropriate to retain Schedules 4 and 8 as liquidated sums compensation regimes?

Yes, the regimes are well understood by both parties, provide incentives and in the case of Schedule 8, clear data on what areas of TOC and Network Rail performance need to be targeted during the development of JPIPs.

Q5.3: Do you think it would benefit customers, funders and society and encourage greater co-operation if Schedule 8 compensation rates from Network Rail to train operators did not reflect the full impact of possessions on revenue and costs? We also welcome any further views on this issue in relation to Schedule 4.

It is disappointing that the ORR repeats, in paragraph 5.18, an unsubstantiated allegation that there are TOCs who would rather "..accept Schedule 4 payments…than work more closely with Network Rail to agree on possessions strategies…". Such anecdotes do not have a place in developing regulatory policy unless they are backed up with evidence and concrete examples.

It is hard to see how less than full compensation rates would encourage greater co-operation by train operators in respect of possessions; if this were the case the incentive for TOCs would be to resist possessions as the short-term impact on their businesses would not be compensated. In addition it would increase the cost of franchising as the risks from the uncompensated effects of poor performance and possessions would be priced into franchise bids.

A proposal is made in the document to delay the payment of Schedule 8 compensation; this appears to arise from a misunderstanding of the how Schedule 8 payments are calculated. The payment rates and multipliers in Schedule 8 are calibrated to provide compensation to the discounted value of the loss of future demand as a consequence of current poor performance, not compensation for revenue lost at the point of delay. It is hard to see what merit there would be in delaying the payment.

Q5.4: Do you think existing incentives are as effective as they can be in ensuring that Network Rail and train operators perform at a level that is economically and socially optimal, and whether they sufficiently drive Network Rail behaviour? In particular, we invite views on whether we should place further incentives on Network Rail to ensure it fully takes into consideration the impact of service disruption on passengers, i.e. disruption above that already reflected in Schedules 4 and 8 compensation payments for loss of fare revenue, and how we could go about doing this.

The existing incentives on train operators and Network Rail extend far beyond those which are contained in Schedule 8. Network Rail faces incentives through its Management Incentive Plan, reputational risk and the PPM measure. TOCs face extremely sharp incentives to meet their franchise performance targets: failure to do so can result in loss of the franchise.

The combination of the principal funders' HLOSs and their franchise specifications represent the closest proxy the industry has for the expression of the societal benefits of good performance and society's willingness or ability to fund them. Whilst it would be possible to construct a mechanism, for instance the re-introduction of the "societal-rate" element of Schedule 8, it would add to the overall cost of the industry and would be likely to be of marginal benefit.

Q5.5: Do you envisage any barriers to modifying or replacing the Schedule 4 and 8 regimes in cases where both a train operator and Network Rail wish to? What do you see as the advantages and disadvantages of bespoke approaches? Do you agree with our proposal regarding the circumstances when we will approve bespoke Schedule 4 and 8 arrangements?

Bespoke Schedule 4 and Schedule 8 mechanisms were widespread during CP1, the only barriers to their continued use have been regulatory.

Bespoke regimes have the advantage that they reflect the reality that not all TOCs are the same – for example long-distance operators historically favoured incentives which worked on a "per-train" rather than per service group basis- and template regimes do not necessarily provide effective incentives across all times of day/days of week. Their disadvantages are that they can cause conflicts on shared routes where operators are subject to different regimes and they are potentially less efficient for Network Rail as specific expertise is required to manage them.

We support your proposal to only approve bespoke regimes which do not undermine the incentives to meet performance objective or minimise disruption.

Q6.1: In what circumstances do you think bespoke charging arrangements are likely to occur? What advantages and disadvantages could such arrangements have? How might they work for or against the alignment of incentives?

Bespoke charges are likely to arise:

- as they do currently where vehicles are modified to be more track friendly;
- when a new class of rolling stock is introduced to a limited geographic area;
- where the variable costs associated with specific infrastructure is significantly different from the average, price list, cost; or
- as part of a joint initiative aimed at generating efficiencies

In most of these circumstances TOC and Network Rail incentives should be aligned. The disadvantages will arise from incorrectly calculated bespoke pricing which may lead to long term inefficiency or misalignment of incentives. The alignment of incentives relies on correct price signals.

Q6.2: What protection do you think might be needed for third parties not included in the scope of a bespoke arrangement?

The standard price lists and template contractual arrangements will continue to exist and will give third parties the ability to plan their business. The Network Licence obliges Network Rail to behave in a non-discriminatory way. If further protections are needed ORR might consider occasional reviews of bespoke arrangements.

Q6.3: Do you agree that it would be helpful for us to set out a set of principles on the basis of which we would decide whether to approve bespoke arrangements? Do you have any views on what those principles should be?

The principles set out in 6.29 for the approval of a bespoke variable usage charge are appropriate.

Q6.4: How do you think we should treat bespoke charging arrangements that might span Network Rail control periods or change within control periods?

The simplest approach would be for bespoke charging arrangements to run concurrently with the track access agreement, remaining outside the periodic review process. The standard price-list would change with the control period and provide a default price for new access agreements.

Q7.1: What are your views, additional to those set out in your response to our May consultation, on our treatment of the following options:

(a) The scope of our proposed review of the volume incentive, including disaggregation by Network Rail route and consideration of a down side as well as an upside?

(b) That we continue to support the rationale for the capacity charge, and will support Network Rail in its work to revisit and recalibrate the charge for PR13?

We support the rationale for a capacity charge, but don't believe that the charge in its current form meets its objectives, nor do we believe that the regime is correctly calibrated. A mechanism which genuinely represents the marginal performance costs of an additional train would offer the right incentives to Network Rail.

To illustrate our concerns you should note that during the RSP year 2010/11, a year which saw Network Rail performance which was sufficiently poor for Southern to refer them to the ORR, Southern paid more than twice as much in capacity charge than it received in liquidated sums from Schedule 8, we find it hard to believe that the balance of Capacity Charge payments was paid out to other users of the route through Schedule 8. This would indicate that the current capacity charge is more a tax on trains than an incentive regime.

(c) That we should establish the extent to which infrastructure capacity is under-utilised before proceeding to develop one or more indicator by which to monitor capacity utilisation?

Infrastructure use should be dependent on freight and passenger demand; some infrastructure being lightly used is a reflection of the prevailing market. A capacity charge which indicates that a route is becoming congested is of value, but it is hard to see the value in establishing under-use, or what incentive mechanisms which might follow from that.

Q7.2: What are your views, additional to those already expressed in your response to our May consultation, on the policy we are considering further to levy a charge to incentivise better use of capacity?

For franchised passenger services you should consider on whom it is that the incentives act. Under the existing franchise model the overwhelming majority of the capacity use is determined by the Service Level Commitment or Train Service Requirement for the franchise with a limited margin of freedom for the operator. The incentive therefore needs to act primarily on the funder and specifier of the franchise.

Q8.1: Do you agree with the criteria that we have applied in assessing different options to Network Rail's cost of capital and our approach to its financial structure?

An option you have not explored is a cost of debt scenario combined with a degree of pay as you go investment funded directly by the funders rather than from surplus cash.

Q8.2: Do you agree that we should use a cost of capital for Network Rail that reflects the risks faced by the business, even though this may not reflect the company's actual financing costs?

As a principle a business should be rewarded for the risks that it takes, but that begs the question: what are those risks? If Network Rail has an unlimited capacity to raise supported debt, then its risk is the cost of debt. If there is a constraint on the level of supported debt it can raise, then the difference between its cost of capital and cost of debt should allow the capability to manage those risks (e.g. through the creation of a buffer).

If Network Rail does raise unsupported debt, its cost of capital should reflect that additional cost, but this should be offset by the additional efficiencies that arise.

Q8.3: How do you think we should deal with the surplus cash that results from such an approach?

If a significant amount of surplus cash arises, i.e. cash beyond what the company reasonably needs to manage risk it would indicate that the cost of capital allowed is too high relative to the cost of debt and therefore inefficient.

The two approaches suggested either a rebate to the funders or a degree of pay as you go (effected either through paying off debt, or direct funding of some capital expenditure) are reasonable approaches. However, a more transparent approach would be to set an efficient cost of capital and allow funders the opportunity to make the decision on whether some investments could be funded on a pay as you go basis within their SoFAs, or spent in other parts of the industry where better outcomes might be delivered.

Q8.4: What advantages and disadvantages do you see in our regulating Network Rail in a way that preserves the options for changes to the company's financial structure?

The immediately obvious disadvantage is that the cost of capital allowed is inefficient as Network Rail is being rewarded for risks it is not taking. To overcome this would it be possible to put a "switch" into the settlement which allowed an increased cost of capital in the event that Network Rail raises unsupported debt?

Q8.5: How should we strike the right balance between the interests of current customers and funders and future customers and funders?

As the consultation document describes, decisions about the cost of capital, in isolation, are decisions about the timing of expenditure. To some extent funders should be in a position to make their own judgements about their future interests.

The fundamental risk arising from the current industry structure for customers is that, due to the long lives of railway assets, RAB funded debt will go on growing for a number of years, this pushes the risk of inappropriately specified investments and inefficient capital expenditure into the future. This being the case assurance that inefficient expenditure is not added to the RAB would go some way towards safeguarding the interests of future customers and maintaining and improving the sustainability of the railway.

Q9.1: How do the incentive properties of our different treatments of different classes of expenditure affect operating decisions on the ground, e.g. is it the potential financial gain or loss that motivates actions or is are decisions more based on other factors such as relative complexity, cultural factors (e.g. tradition or professionalism) or the nature of Network Rail's financing and governance arrangements?

This is a question for the principal funders of the railway.

Q9.2: Are the incentives on Network Rail affected by the different ways we may assess support, operations and maintenance costs, compared to renewals and enhancements expenditure? In particular, we may use a base year for support costs that is rolled forward by an efficiency assumption, whereas for renewals we will probably not roll forward a base year but will take a view on the likely level of expenditure in each year on a pre-efficient basis and then apply an efficiency assumption.

This is a question for the principal funders of the railway.

Q9.3: Do you expect Network Rail's work on whole-life costs to change its decision-making, and in what way?

This is a question for the principal funders of the railway.

Q9.4: Is there any evidence of ‘capex bias’ at Network Rail? To what extent is this undesirable?

The difference between Network Rail’s cost of capital and cost of debt creates a clear incentive towards capex as it effectively creates cash-flow, although it is argued that the surplus cash is used to pay off debt or to make rebates through the track access agreement.

The extent to which it is undesirable is the effect on the sustainability of Network Rail’s financing, which is dependent on the long-term cost of Network Rail’s debt and the decisions that Network Rail and funders reach in respect of the use of surplus cash.

Q9.5: Should we seek to equalise the incentives for different types of income and expenditure? How best might we do this?

Whether incentives should be equalised depends on how great the undesirable consequences of a bias towards capex are and the extent to which there is evidence that Network Rail’s accounting treatment of expenditure has been distorted.

Narrowing the gap between cost of debt and cost of capital would achieve this.

Q10.1: Do you agree with our overall proposed approach to incentivising innovation? If not, what do you propose we do instead?

We support the approach of setting tough efficiency targets for Network Rail as the principal mechanism for driving innovation.

Q10.2: What merit do you think there would be an innovation fund? How should such a fund work? How would we guard against ‘crowding out’ and ensure the fund did not displace existing expenditure?

We have no comment to make on this.

Q10.3: What merit do you think there would be in an innovation prize? How should such a prize work? Who should be eligible to enter? What sort of prize would best stimulate genuine innovation?

We have no comment to make on this.

Q10.4: In relation to the use of output KPIs, what KPIs do you think we should target and why? Should we monitor them only or should they have some incentive attached to them and if so what?

The consultation document does not offer sufficient detail on where the innovation gap is to allow consideration of the development of KPIs. An assessment of where Network Rail lags its peers in terms of delivering efficiency through innovation would be a helpful starting point.

Q10.5: Do you think that KPIs should be introduced for companies other than Network Rail to monitor innovation across the wider industry?

This would end up as a bureaucratic exercise which is unlikely to add any value to the industry.

Q10.6: Beyond any comments that you may have made to us in response to our May consultation, do you have any comments on our overall approach to environmental incentives? Specifically, do you think we should introduce other environmental incentives beyond those that we are proposing? Do you think we should go further in encouraging the rail industry to improve its environmental performance even if this resulted in a shift to other modes?

We have no comment to make on this.

Q10.7: We are keen for the industry to propose methodologies for monitoring emissions and producing improved whole-life, whole-industry business cases. What role do you think the ORR should play in this process

We have no comment to make on this.