

## ORR PR13 Consultation on Incentives

### Response from Rail Freight Group

January 2012

1. Rail Freight Group (RFG) is pleased to respond to the ORR's PR13 consultation on incentives. This response may be placed on ORR's website in full.
2. RFG recognises the imperative of improving rail's cost efficiency, and supports ORR in seeking measures which can help to reduce costs and deliver greater outputs from the rail network. However, we continue to be concerned that the implementation of some measures may in fact have a negative impact on freight operators, customers and potential customers. We have set out our concerns in this response.

#### *Context for Rail Freight*

3. Rail freight represents under 10% of UK rail traffic, and around 11% of UK surface freight transport. Operating in the private sector it has greater commercial freedom than most other rail operators, but is considerably more constrained and regulated than the other 89% of UK freight movement (principally HGV) with which it competes for business. Incentives which are designed to target the franchised sector may often not be a good fit for the freight sector, and risk increasing the level of complexity compared to the road freight, hindering the competitive position.
4. Rail freight's customers and its potential customers have a good understanding of road transport but often little understanding of rail transport; they already consider rail transport to be complicated and slow to respond. It is therefore vital that any changes to the incentives structure do not have a negative impact on these commercial relationships and do not increase the level of complexity.
5. As we suggested in our response to the May 11 consultation, we consider this is most likely to be achieved if
  - a. The overall structure is straightforward and clear, and the number of charging objectives is small;
  - b. The desired changes are in the gift of the operator to deliver;
  - c. The likely outcomes align with the overall objectives of the railway and freight sectors;
  - d. The potential for perverse outcomes is minimised, overall and between competing operators on the network.
6. The total financial exposure, and level of risk, from access charges and incentive schemes must also be considered. This is particularly vital for small operators, and must recognise the overall low levels of profitability in the sector. Any new incentives should also not cause an increase in administrative costs for freight operators, who are generally thinly staffed and may not wish to 'resource up' to administer any new regimes.
7. Our specific comments are provided below,

#### *Chapter 2 – Background and Context*

8. Para 2.17 Transparency. We note that a document on transparency is to be published shortly. As rail freight operates in the private sector, we would expect that the

requirements placed on rail freight operators would be comparable with those placed on competing road operators.

9. Para 2.20 Market Mechanism. We agree that market mechanisms have an important role to play, but for this to be truly effective, the mechanisms need to apply to all operators in the sector. We note that the ITT for the new West Coast franchise does exclude benefit sharing from the pass through of access charges, but it will be many years before this is common to all franchises. The replacement for cap and collar mechanism must also be assessed to see if it blunts the effect of incentive mechanisms in any way.

### *Chapter 3*

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

10. Yes.

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

11. Broadly we agree with the assessment. For some freight customers, satisfaction is likely to be influenced by factors across the entire logistics chain, as well as those specific to the rail part of any movement. Rail cannot be viewed in isolation from the rest of logistics.

*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?*

12. We recognise that there will need to be trade offs between different interests, and that ORR has a critical role to play in this area. With the pressure on costs, it is obvious that the requirements of funders are important, but short term financial requirements alone cannot be given primacy. The Logistics Growth Review, published by Government at the end of 2011 emphasises the key importance of logistics, including rail, for UK businesses, and we would expect macro level considerations such as this to form part of the considerations.
13. Trade offs should also be based on a reasonable future timescale. Decisions on access for example, can only look at the specific service proposals which have been applied for at that time, yet in fact a longer term analysis might lead to a different solution, with more consideration of strategic capacity needs.

*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?*

14. ORR must verify that the incentives it sets are actually delivering the outcomes it desires. It should also ensure that the impact of the incentives is positive and proportionate for all. It also needs to review the incentives to ensure they remain fit for purpose.

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?*

15. Network Rail need to develop the appropriate corporate culture to deliver against outcomes. It remains unclear to us how the delivery of outcomes will be managed in the devolved structure particularly where success relies on a network wide approach (for example, in planning possessions to achieve the network availability target).

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?*

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?*

16. As above, the emerging company culture under devolution is important. Freight operators are keen to understand in more detail how the Network Operations role will develop. This area is key in ensuring that incentives for the freight sector are delivered and aligned.

#### *Chapter 4: Aligning Network Rail and Train Operator's Incentives to increase efficiency*

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

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 do you think they will improve the incentives on train operators to work with Network Rail to reduce its costs?*

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?*

17. Clearly, exposing operators to changes in Network Rail's costs could encourage them to work with Network Rail on lower cost solutions. Experience with the freight operators and variable charge has demonstrated that exposure to changes in the variable charge has led to extensive participation at periodic reviews.

18. The existing EBSM scheme has been in place for 2 years now, but has not yet paid out. It would be interesting to understand how this mechanism has driven behaviour for the operators it applied to, and whether it has encouraged any changes in their relationship with Network Rail. It may be too early to determine whether it has been successful or not, and thus whether the principle is sound.

19. We have a number of concerns over the proposals for a wider, compulsory scheme with up and down side risk. These can be summarised as follows;

20. *Effective Participation* Although the scheme will be compulsory, we note that for many of the passenger franchises, the terms of their contracts are such that their ability or interest in participating may be tempered, unless the payments under the scheme can be excluded from pass back to Govt, cap / collar arrangements, and franchise review points. This will take some years to achieve. It would be concerning if freight operators were at risk for underperformance whilst the 'lead' passenger operator was able to offset the risk

wholly.

21. *Resource* For freight operators who operate on a national basis, the ability to effectively engage with up to 10 different schemes must be questionable. It would be a policy failure if, for example, the freight operators had to recruit additional staff simply to participate in the scheme. This is particularly acute for smaller operators. It is also of note that many of the efficiency measures that may be identified for freight operators could be cross route – e.g. in possession management – and it is unclear how this would be incorporated.
22. The financial affordability on operators may also need to be considered, particularly as there is no opt out of the scheme. Competing modes do not bear any similar risks.
23. *Ability to Influence Network Rail* To be successful, operators must be able to influence Network Rail behaviour, as well as changing their own actions. This may be difficult, particularly for smaller operators, who face a 'David and Goliath' situation, and for whom the consequences of failure may be more severely felt than they will be for Network Rail. For complex areas, such as challenging standards, this will be particularly difficult.
24. There may also be a tendency to focus on output reduction as a quick way of reducing costs and measures to protect third party outputs may need to be considered – for example, removing currently unused freight connections during a renewal. If an operator has a reasonable objection to a proposal for cost reduction this should not impact on their participation in the scheme.
25. The recent consultation on freight caps demonstrates that Network Rail still have a fairly poor understanding of the level of freight costs, particularly on freight only lines. This is likely to make it more difficult to accurately identify cost saving opportunities.
26. *Measurement* The consultation is not clear on how efficiency savings will be measured, and how individual operator participation will be judged. Participation will presumably only be tested for 'upside' payments, whilst 'downside' payments will be levied in any event. It must be clear who will be assessing participation, and what criteria will apply.
27. In summary therefore, we have a number of concerns over how the regime would work in practice for freight operators. More detailed development is necessary, and it may be appropriate for a trial to be undertaken involving a route and franchise who is exposed to such a regime. Meanwhile, more analysis of the performance of the existing regime may be useful, as would the conclusion of the assessment for last year's performance.

*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?*

28. Generally, we would oppose bespoke arrangements which put one freight operator on a different commercial basis to the others. However, there may be circumstances where bespoke arrangements might apply to particular topics or groups of operators. For example, the treatment of freight only lines, or connections, if particularly innovative solutions were being considered.

*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?*

29. There is insufficient detail to judge at this stage. The analysis of whether freight can afford to contribute to fixed charges, which ORR are currently considering, may be relevant.

#### *Chapter 5 Possessions and Performance Regimes*

*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?*

30. Broadly we consider that the existing Schedule 4 and Schedule 8 schemes are working effectively.

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

31. No comment

*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.*

32. In both these cases, we are concerned that the proposed incentive is not sufficiently well targeted for freight operators. Freight performance is currently the subject of Regulatory Enforcement, and work is underway to consider new metrics. There may, as capacity constraints increase, need to be areas where the interaction of freight performance and freight scheduling are considered, for example in the treatment of late starts from terminals. Overall, these areas are not yet well worked out, and it is therefore unclear what behaviour needs to be incentivised.

33. For possessions, again there is a lack of clarity. Some commentators suggest that overnight freight traffic is a significant cause of possession costs, yet when challenged with this in business case development, Network Rail have been unable to identify cost savings. The development of the Freight Joint Network Availability Statement is identifying ways to maximise possession windows by using diversionary strategies, but the management and delivery of this, particularly in a devolved structure is not proven.

34. We consider therefore that it is premature to consider making freight operators at risk for part of the losses from delay and possessions before it is clear which behaviour we are seeking to incentivise. The financial exposure for freight operators must be considered, in light of the contractual frameworks that they have with their customers – which are bespoke in each case.

*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.*

35. Generally, we would consider that the freight operators are best placed to manage performance impacts with their customers. Given the differing requirements of freight customers, it would be difficult to make generalised assumptions about the impacts on customers.
36. A stronger volume incentive may encourage Network Rail to develop a possession regime which supports greater levels of weekend services.

*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?*

37. Generally, we would oppose bespoke arrangements which put one freight operator on a different commercial basis to the others.

#### *Chapter 6 Access Charges*

*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?*

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

*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?*

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

38. Charges for freight operators must be transparent and non discriminatory, and should not lead to competitive advantage or disadvantage for any operator or supplier. So the circumstances where a bespoke arrangement is likely to be valid are likely to be few. However there could be cases where this is appropriate. In such cases the bespoke arrangement must be available to all operators on an equal basis and treat all rolling stock in a fair manner, whoever it is owned by.
39. We have no particular comment on bespoke arrangements for passenger operators.

#### *Chapter 7*

*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?*

*(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?*

40. The volume incentive is weak, but presently is the only incentive on Network Rail to seek to accommodate more freight traffic. To that end we support it, and consider that it could be strengthened.
41. As most freight services span more than one route, separating the volume incentive by route may be difficult, although it would certainly be appropriate for all Route Directors to be incentivised to encourage freight services.
42. As the capacity charge is the same for all freight services Monday – Friday, including those which run overnight, it has no incentive on behaviour at all. It is, in effect, a mark up to the variable charge for freight operators. (However, we note that, as it is not classed as such, it is not subject to the affordability test and other protections which do apply to the variable charge.)
43. As the charge is set in advance for the control period, it appears to have little influence over either performance, or Network Rail's ability to increase volumes. It is therefore unclear what the incentive effect is.
44. Although we support the principle of metrics for capacity utilisation, in reality we think it is likely to be difficult to get a meaningful measure. For freight operators, useful capacity needs to be connected throughout the journey, and to slot at ports and terminals, and have acceptable journey time and performance. A link to the development of Strategic Capacity may be more productive.

*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?*

45. We support the present position on reservation charges.
46. Our concerns on scarcity charging remain. In particular, this consultation still does not discuss how the scarcity charge would balance all ORR's duties and would not prioritise the granting of access simply for the most cash rich operators.

#### *Chapter 8 Network Rail's Cost of Capital and Financing Arrangements*

*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?*

*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?*

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

*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?*

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

47. We have no comment on the details, but it is important that ORR have a view to the long term sustainability of the railway.

#### *The Incentive Properties of Opex and Capex Cost Recovery*

*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?*

*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.*

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

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

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

48. We have no comment on the specific financing points. However, capex solutions are often easier to deliver than changes to systems or standards. So, for example, it is easier to build a freight loop than to investigate increasing freight train speeds, or developing strategic capacity and enforcing Part J, or challenging passenger service requirements with DfT. A focus on some key areas in CP5 may help with managing future capex demands.

#### *Other Incentives*

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

*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?*

*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?*

*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?*

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



49. We agree that encouraging innovation will be a key part of reducing rail costs. Network Rail's efficiency targets have been a strong driver for them in developing innovation. In the freight sector, market demands have also led to some innovation and development. In these cases, the supply sector, and the customers have often taken the lead on research and development projects, using in some cases experience in other sectors.
50. Issues which frequently arise with introducing new technology include the costs of meeting specific UK requirements (such as gauge), compliance with standards, and in some cases getting accurate asset information. Such areas are of concern, but are unlikely to be resolved through an incentives framework.
51. For other cross industry areas, such as ERTMS fitment, lack of alignment of incentives is often cited as a reason for delay. Yet in many cases the detailed work is also lacking, or the necessary commercial negotiation has not taken place. It is unclear whether an incentives scheme has much to offer.
52. Elsewhere there are various funds available for innovation and research in the rail sector, including Marco Polo, Technology Strategy Board funding and European transport research funding. We are therefore not convinced that an additional innovation fund is a good use of funds.

*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?*

*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?*

53. We strongly oppose measures which lead to reverse modal shift. This would be perverse. However we do agree that ORR should act to encourage best practice in environmental performance.
54. ORR ensure that the information it collects already on environmental performance is fit for purpose as the basis of future monitoring and development. It should also ensure that its decisions – for example, in granting access, pay due regard to environmental performance.