## Responses to consultation on Working paper 6: The Volume Incentive


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5th January 2018

**Introduction**

These comments respond to the ORR's Working Paper 6 on the Volume Incentive. The response is provided on behalf of Arriva plc, its subsidiary Arriva UK Trains Limited and its wholly owned train operating companies (TOCs), Arriva Rail London Limited, Arriva Rail North Limited, Arriva Trains Wales/Trenau Arriva Cymru Limited (ATW), Grand Central Rail Company Limited, The Chiltern Railway Company Limited (CR) and XC Trains Limited (XC). Arriva is a wholly owned subsidiary of Deutsche Bahn AG (DB AG).

Arriva views the Periodic Review (PR18) process as an important element of a coordinated series of activities necessary to ensure that all elements of the Rail Industry structure work together to support the delivery of the vital contribution that rail needs to make to society in the UK. Therefore, Arriva has played an active part in the Periodic Review process to date and intends to do so going forward. In particular, Arriva is actively supporting and inputting into the coordinated industry activity being undertaken by the Rail Delivery Group (RDG).

On this basis, Arriva endorses the responses provided to ORR by RDG relating to the consultation documents issued by ORR to date and confirms that Arriva's views are firmly reflected in the RDG response.

Regardless, Arriva would like to take this opportunity to emphasis a few key points that have emerged through the work undertaken to date and that are set out in the following response.

**Do you think the volume incentive has made a significant contribution in CP5 to Network Rail's incentives to add services to the network?**

In our experience, the volume incentive has not evidently influenced Network Rail's behaviour during CP5, particularly regarding decisions about adding [additional train] services to the network. Despite the measure being designed to reward the growth of passenger and freight traffic on the network, we believe the following key factors have limited the value of the volume incentive in CP5:

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- The financial value of the volume incentive appears to be weighted more lightly in Network Rail's decision making processes on access than other factors – notably performance. It appears that the financial and reputational penalties Network Rail face for any performance detriment are given more weight by both the Routes and System Operator functions than the financial uplift generated by the volume incentive.

- The complexity of the volume incentive, with its four incentive metrics (Passenger train miles, Passenger farebox, Freight train miles and Freight gross tonne miles as shown on Page 7 of the working paper) and baselines scaled at Route-level, means that the relationship between volume growth and financial reward over a particular line of route is not clear. This makes it more difficult for either the Routes or System Operator to take ownership of performance against the volume incentive. The five yearly memorandum account process decouples the income from increases in traffic linked to timetable changes. This may be a factor in explaining why Network Rail appear not to weight the volume incentive highly in decisions regarding use of the network.

- The route-based scale which the volume incentive is applied can also result in local uplifts in traffic being diluted by wider external macro-economic factors impacting passenger and freight commodity flows. This further reduces the incentive qualities of the mechanism. This is evident in the working paper showing the cumulative value of the volume incentive over the first three years of CP5 as -£25m, during a time of traffic growth.

- As mentioned by ORR in the Working Paper, Network Rail's reclassification as a government entity results in the volume incentive forming a circular financial flow within government.

**<u>Which of the three high-level options we have set out above do you think we should take forward? Could you explain your main reasons for supporting this option?</u>**

- Cognisant of the removal of the Capacity Charge proposed through the wider PR18 process, Arriva believe that Option 2 should be pursued so that a form of volume incentive is retained but with material improvements to its design.

- This is the case as we support the principle behind the current mechanism but find its application to be flawed. At a time when ambitious plans to improve the rail service offering for passengers can be viewed by Network Rail as a compromise between capacity and performance, Network Rail must be incentivised to boost passenger growth through most effectivity utilising the capacity of the network.

- Network Rail's System Operator function requires an incentive to work with the Routes to continually forecast network capacity, actively plan to support traffic growth, and be creative in how it validates timetable bids to maximise available capacity.

**<u>If you think we should take forward option 2 (remove the volume incentive in CP6 and replace it with an alternative), do you have any ideas for additional changes that we should consider to improve the balance of incentives?</u>**

- If ORR were to base a new incentive mechanism on the structure of the current volume incentive, then the mechanism should be simplified. For example, by removing Passenger Farebox and Freight Gross Tonne Miles and applying Passenger and Freight miles as consistent and standardised metrics. This avoids the impact and complexity of wider macro-economic factors that can distort the volume incentive.

- The System Operator should take greater ownership of the new incentive mechanism through inclusion in its scorecard, with potential for this to become an outcome regulated by ORR to ensure that it is given enough weight in access decisions on capacity. Arriva notes the significant growth in passenger volumes forecast across the UK rail network during CP6 in beyond, Network Rail predicting that passenger numbers are not only growing by 6% per year, but will double over the next 25 years. The new incentive mechanism must support Network Rail in accommodating demand growth whilst maintaining robust performance. Work is therefore required to use the new incentive mechanism as a basis for the development of targets for traffic growth on the network. As a consistent measure there is also scope for the new incentive mechanism to be used to enable comparison between the routes.

- More streamlined data systems are required to ensure that the Network Rail sees the impact of the new incentive mechanism as a direct result of the uplift in train mileage stemming from a given timetable change. This follows a similar principle to the proposals outlined with ORR's September consultation on levying Fixed Charges. If this is achieved, the new incentive mechanism has the potential to provide sufficient reward to Network Rail for adding traffic, to avoid the need to "variablise" fixed charges on operators during CP6.

- Greater transparency is required regarding how any financial gain deriving from the new incentive mechanism is utilised by Network Rail. Directing the financial benefit where it is most needed, such as towards passenger-facing improvements, will increase value of the new incentive mechanism as a reward and promote behavioural change and promote reputational benefit.

**<u>Do you think there are potential reputational incentives from Network Rail continuing to report on its performance against the volume metrics used to calculate the volume incentive, even if the financial aspect is removed?</u>**

- Any reputational incentives from Network Rail reporting against the volume metrics, noting the points above, can only be achieved through greater ownership of the new incentive mechanism as a KPI against which Network Rail is measured.

- As also noted above, simplification of the metrics is crucial to establishing this ownership, and greater visibility of the measure as a factor in decision making.

- Most crucially, achievement of targets for the new incentive mechanism must consistently be factored into the Network Rail SoAR process. Network Rail's performance against a renewed and more effective volume incentive mechanism must be afforded sufficient weight against other factors under consideration when selling Access Rights. The methodology behind weighting the mechanism in comparison to other factors must also be structured and transparent.

- The financial and/or reputational significance of the traffic growth must be regarded as equal to the financial and reputational value placed by Network Rail on network performance when making decisions on capacity utilisation.

- There is scope for further research to increase the reputational benefit to Network Rail of adding traffic beyond the metrics described within the working paper, such as growth in passenger journeys. This links into wider strategic importance of promoting a modal shift away from the car and onto the railway.

Yours sincerely,

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[redacted]

29th January 2018

Dear Natasha,

Thank you for giving the Department for Transport the opportunity to comment on the ORR's proposals for the role and design of the volume incentive in Control Period 6 (CP6).

**Introduction**

To help address the capacity challenge, the Government has been pursuing the most extensive programme of modernisation in Britain's railways since Victorian times. Our Statement of Funds Available for CP6 supports rail spending of around £48bn, focussed on the things that matter most to passengers – a safer, more reliable railway. Alongside that we are investing in significant new capacity through major projects like HS2, Thameslink, Crossrail, East West Rail and the Great North Rail project. Recent franchises have included longer trains and new Intercity Express Trains are replacing the ageing High Speed Train fleet, providing improved services and additional capacity between London and major UK cities. The Government's Rail Freight Strategy identifies the importance of network capacity in empowering rail freight to achieve its full potential. Alongside investment in infrastructure, we want to see the industry working to identify options for making better use of the existing network without costly and often disruptive interventions.

In that light, DfT supports ORR's proposals as set out in the working paper. Our overall view is that, in its current form, the volume incentive has material limitations which mean that it has been ineffective in practice in creating incentives on NR to meet unmet demand. In the light of NR's changed public status we also consider it unlikely that a redesigned volume incentive would be effective. Indeed, it would be likely to risk additional complexity to the regulatory system.

Instead, we believe that the full implementation of NR's transformation plan and the measures set out in the Secretary of State's rail strategy can create an environment in which the market has better incentives to deliver more effectively, supporting growth. In particular, we regard the Route Supervisory Boards and the use of balanced scorecards as playing an important role in influencing NR to be more responsive to the needs of its customers, including responding to unanticipated growth and accommodating additional traffic on the network.

**<u>Our responses to ORR's specific questions</u>** are set out below.

**Do you think the volume incentive has made a significant contribution to NR's incentives to add services to the network?**

Although the volume incentive has made a marginal contribution in the absence of other direct incentives to grow capacity, we believe that it has not had a significant impact. DfT's view is that it is important that there are appropriate alternative ways to achieve the objective of increasing network capacity and usage, while recognising the need to consider the interplay with cost and performance. DfT agrees with ORR's assessment in paragraphs 3.11 to 3.18 of the working paper that changes to Network Rail's structure and regulation provide the opportunity to encourage the introduction of new services without retaining the volume incentive in its current form. DfT wants to see these changes lead to an industry culture in which track and train work in partnership to respond to customer demand effectively at a local level whilst maximising the useable capacity of the network as a whole through improved service planning and efficiency.

**Which of the three high-level options we have set out above do you think we should take forward? Could you explain your main reasons for supporting this option?**

DfT supports ORR's approach described under Option 2 for CP6. DfT considers that there is the potential to remove the volume incentive entirely (Option 3) in CP7 as the competitive and commercial relationship through better joining up track and train through route devolution matures and – depending on the outcome of ORR's review of infrastructure cost charging – the approach to recovering infrastructure costs is reformed. Although DfT notes that the financial element of the volume incentive has in some cases served to give NR a final "nudge" towards accepting additional services onto the network, our view is that there are better mechanisms for achieving the desired outcome - for example, through the effective use of better track-train partnerships, Route Supervisory Boards and scorecards. However, continued reporting on a notional financial impact (as ORR suggests in paragraph 4.2) could have an incentive effect and provide a degree of transparency over changes in how the network is being used, whilst also mindful of the need for continued visibility of performance in this area.

**Do you think there are potential reputational incentives from NR continuing to report on its performance against the volume metrics used to calculate the volume incentive, even if the financial aspect is removed?**

Managing capacity efficiently and effectively to meet current and changing demand is fundamental to NR's reputation as an effective infrastructure operator and is critical to the interests of its direct customers (the train and freight operating companies), passengers, and to government's objectives for the railway and the wider economy. As DfT stated in our response to ORR's working papers on system operation we are looking to NR "to help government deliver its strategic objective to increase rail capacity to meet demand, by having an expert understanding of the existing system capability, and by developing options for using the network better – including through revisions of standards, timetables and systems."

DfT agrees with ORR's assessment (Table 3.1) that NR's new relationship with funders and customers should mean increased focus on non-financial incentives, such as scorecards. We agree with ORR that, instead, route scorecards could reflect volume-related measures to incentivise routes to add more traffic. DfT notes (Table 3.1) that the system operator's scorecard will include measures related to the production of the timetable, but not related to capacity use or production more generally. We would like to see clearer incentives on NR to provide higher-quality advice and make more effective decisions about the trade-offs between increasing the use of the network, operational performance and cost, and enabling NR to be better held to account for its advice and decisions in that area. However, in order for this to be effective, the system operator must be, as the ORR notes, "proactive" and demonstrate the necessary capability, and take action to increase its capability in this area as appropriate. As a key requirement of DfT as customer for the system operator, we would like to see NR develop a measure or measures which reflect the quality of its work in supporting better use of the network, whether at route or system operator level. We consider that ORR has a critical role through PR18 in securing this, building on NR's work. We remain interested in reporting on the overall use of the network and additional traffic accommodated, but as there are a lot of factors which cause movement in that headline figure it would be beneficial to identify measures which more closely reflect the system operator or routes' contribution to making better use of the network.

DfT notes that ORR intends to remove the capacity charge in CP6 and that, if this were combined with removal of the volume incentive payment, NR's financial incentives to add services to the network could be limited at best. However, DfT's view is that this impact could be mitigated by ORR's work to develop infrastructure cost charges in CP6, specifically its work to extend fixed cost recovery through infrastructure cost charges to all operators, subject to the market-can-bear test. DfT also agrees that a benefit of infrastructure cost charges would be that NR would receive this income within the control period, rather than – as with the volume incentive - being credited to or deducted from NR's revenue requirement for the next control period, thus potentially creating a stronger incentive by providing a link between NR's within-period income and unanticipated growth on the network.

**If you think we should take forward option 2 (remove the volume incentive in CP6 and replace it with an alternative mechanism), do you have any ideas for additional changes that we should consider to improve the balance of incentives?**

As well as the availability of adequate capacity, users of the railway also place a very high value on reliability. It is important that any volume incentive mechanism requires NR to engage closely with all affected service providers, taking full advantage of the closer working between NR and the train operator. This should help it to understand the needs of customers better and make appropriate trade-offs between capacity and performance, as well as cost. It should also incentivise the industry to consider all the options for increasing the capacity of the network, not only the case for adding further services (e.g. through more efficient timetable planning and the potential impact of new technologies etc.)

The incentive mechanism should also take into account both short-term/local and long-term/strategic growth objectives and have the flexibility to make appropriate trade-offs between them.

**Conclusion**
Ensuring that NR is able to accommodate unanticipated growth is an important issue on our expanding railway, helping to deliver the railway that passengers and communities deserve.

DfT considers that the volume incentive has had a very limited effect. Instead, we agree that reforms to NR, particularly more integrated working between track and train, route devolution and an increased focus on system operation provide more effective, sustainable means to support and accommodate unanticipated demand.

DfT will be happy to continue to engage directly with ORR as it develops its proposals in the light of responses to this consultation.

Yours Sincerely,

Phil West

Phil West
Director, Rail Strategy & Security and One Railway

**Office of Rail and Road PR18 Consultation**

**Working paper 6: The Volume Incentive**

**Response from Freightliner Group**

**January 2018**

**INTRODUCTION**

This is the response of Freightliner Group Limited encompassing its subsidiaries Freightliner Limited and Freightliner Heavy Haul Limited to the Office of Rail and Road's (ORR) working paper on the Volume Incentive.

**PERIODIC REVIEW PRIORITIES**

Freightliner's priorities for the Periodic Review 2018 are:

- A continued emphasis on improving safety
- A stable, national and simple charging and incentives framework, which does not increase the overall level of net costs borne by freight operators
- Reducing overall industry unit costs and delivering efficiency
- A greater focus on optimisation of capacity and careful balancing of passenger and freight needs by the System Operator
- Delivery of value for money outputs through a long term programme of infrastructure
- A customer focused ethic throughout Network Rail and a supplier who wants our business to be successful

**EXECUTIVE SUMMARY**

- **Freightliner supports the retention of a Volume Incentive in some form, although we recognise it is not straightforward to construct an incentive with real bite**
- **Retaining a Volume Incentive will help to support messages to Network Rail employees that it is important to support growth as well as good performance**
- **In order to make the regime as simple as possible to understand and brief to employees it should be as simple as possible and the payments should be made as soon as possible after new services commence (preferably the following year)**
- **We would be concerned if any replacement mechanism applied only to franchised passenger operators, as this would appear to send the wrong message about supporting rail freight growth**
- **As well as a Volume Incentive we would support a Volume Incentive being a key part of each Route and the System Operator scorecards for CP6**

**Do you think the Volume Incentive has made a significant contribution in CP5 to Network Rail's incentives to add services to the network?**

It is not apparent that the current Volume Incentive has made significant contribution to Network Rail's incentives to add services to the network. The current mechanism is complicated and is probably only understood by a handful of people within Network Rail. In contrast every single employee will be aware of performance targets and how his or her Route is performing against them.

Because decisions on access are now made in one place centrally by the Sale of Access Rights Panel it is assumed (although we have no evidence of this) that part of the papers submitted to the panel is the financial impact of the Volume Incentive and therefore it is more likely that the financial impact is now a contribution to any decision, than prior to decisions being made centrally. This is one of the major benefits of having a centralised Sale of Access Rights Panel. Whilst concerns still remain about the transparency of decisions by the panel and the criteria which the panel use to make decisions we are supportive in principle of the panel and note that Network Rail are commencing discussions with train operators about how the panel can be improved.

The largest challenge around incentivising growth is that the importance of performance of trains is wholly ingrained in the culture of Network Rail and its employees, whilst the importance of growth to the UK economy is not widely understood. Perhaps a reflection of this is, that not many of the geographic Routes have included a volume metric in the scorecards in their draft versions of the Strategic Business Plans. Even in the cases where some sort of volume metric has been included in draft scorecards, the weighting of this measure versus the many different performance metrics is unclear; but on face value the weighting is much less than for performance metrics.

One of the advantages of the CP5 mechanism over the CP4 mechanism is that that all applications for access right have a positive financial impact (either in reducing payout or by increasing payment). This makes it much clearer to assess the financial impact of any one application.

**Which of the three high-level options we have set out above do you think we should take forward? Could you explain your main reasons for supporting this option?**

**Option 1: retain the existing mechanism, with potential improvements to its design.**

Freightliner supports retaining a Volume Incentive. We note that Network Rail remain strongly incentivised by the financial impacts of the Schedule 8 incentive regime and therefore should also remain strongly incentivised by other financial incentives.

In our view, within Network Rail, there is currently insufficient emphasis on growth and limited knowledge of the benefits of growth to both local and national economies. Many of these benefits fall outside the railway balance sheet, but are very important to the UK.

Alongside a continued financial incentive we would strongly support a separate passenger and freight volume metric in every Route and the System Operators' scorecard, with sufficient weight and prominence so that more Network Rail employees recognise growth as important.

We would also support more information and better briefings to Network Rail staff with regard to the benefits of growth to the UK economy so that they can better understand the contribution that their Route is making in supporting new traffic.

**Option 2: Remove the Volume Incentive in CP6 and replace it with an alternative mechanism**

Freightliner would be concerned if an alternative mechanism, such as an infrastructure cost charges applied only to franchised passenger operators. Our concern would be that there would be an incentive to favour franchise operator applications over applications for freight operators. It is already challenging for freight operators to make their case when the role of freight in the economy is not so well understood, and the trains are not backed up by franchise agreements. Freight operators have a more diluted relationship with the geographic Routes and employees may be less aware of new services starting and their role in serving a customer or customers in a sector.

**Option 3: remove the Volume Incentive in CP6.**

Freightliner would favour a strengthening of incentives rather than removing them.

**If you think we should take forward option 1 (retain the existing mechanism), do you have any views on the current design of the Volume Incentive, and how it could be improved going forward?**

We recognise that it is not easy to design a Volume Incentive that is both effective and makes sense given Network Rail's unique financial position. Just by having such a mechanism however, it sends an important message that growing the number of trains on the network is important.

Freightliner would therefore support a stronger incentive whereby the payments were made annually to each Route, so that the payment is made as soon as possible after new traffic has commenced. This would be more understandable by employees and create a more direct incentive.

The Volume Incentive should be as simple as possible and we suggest just one measure for each of the passenger and freights sectors. Specifically for freight we would support a Volume Incentive that just measures tonne miles (either gross or net), rather than the current 2 part mechanism that measures both train miles and tonne miles. One of the key aims of freight operators is to become ever more efficient and in this regard moving more freight on every train is very important, so it is equally as important for freight operators to have support for Network Rail to run longer trains as it is to run new services.

**Do you think there are potential reputational incentives from Network Rail continuing to report on its performance against the volume metrics used to calculate the Volume Incentive, even if the financial aspect is removed?**

Our concern with this option would be that the Volume Incentive would be lost amongst the many other metrics. The failure to meet a volume target may not be considered as a reputational incentive on Network Rail, given that they are only partly responsible for enabling new growth. If a reported Volume Incentive has no financial bite or impact on staff bonuses, there is a risk that it will be considered rather inconsequential.

**If you think we should take forward option 2 (remove the Volume Incentive in CP6 and replace it with an alternative mechanism), do you have ideas for additional changes that we should consider to improve the balance of incentives?**

This option creates challenges in relation to the charges paid by freight operators. Freight operators support a simplified charging structure that enables them to compete directly with road hauliers. The recently closed ORR consultation regarding the ability of the rail freight sector to pay mark-ups concluded that only electricity coal, biomass, nuclear waste and iron ore could afford to pay a mark-up over and above the directly incurred charges. Paying additional charges in order to incentivise Network Rail would be unaffordable in the same way as a mark-up has been deemed to be unaffordable. The risk would therefore be that any additional charges paid by the rail freight sector would actually have the opposite effect of incentivising more volumes to move by rail.

£1.7 billion of externality and economic benefits are created by moving freight by rail, and these benefits fall to the UK, not to Network Rail. This supports the rationale of having a Volume Incentive that is in effect paid for by the government in recognition of these benefits.

Heritage Railway Association (HRA) response to ORR consultation on

Working Paper 6: The Volume Incentive

This is the HRA response to the volume incentive consultation.

As an organisation the Heritage Railway Association is concerned that any changes to the volume incentive will not prevent our members to use the national network in the way they currently do.  Plus that the incentive still leaves sufficient space in the timetable for new services to use the network as and when our members (including members that don't current use the national network) find them worthwhile running.

We are also concerned that the incentive is not so effective that charter operators find there is insufficient capacity left on the Network for their operations.

Rather than an incentive, what is really required is an effective way that Network Rail can recast the timetable on a weekly basis to remove all the timetable inefficiencies, such as pathing time, that could built up over time.  This plan would include the protection of capacity for freight.

We would prefer to see that the power of ITPS is unleased, with the use of modelling for the timing of each train and automatic conflict detection, so that an efficient timetable plan can be developed at T-8 to T-5 for go live at T-4 for all 7 days and for all operators.  A plan based on what the operators want to run that week including charters.  Which we think would be far more effective than an incentive.  This would have the added advantage of allowing Network Rail time to have firmed up its engineering access requirements by then.  Once this plan is in place then any access proposals post T-4 would be subject to planning round any engineering access already agreed.

So we think the financial settlement should be set up to provide adequate funding for Network Rail for the system operator role. With the settlement having specific requirements for Network Rail to recruit and retain suitable staff in Milton Keynes for effective timetable planning.

Ian Leigh

Finance Director

Heritage Railway Association

**Network Rail Infrastructure Limited's response to ORR's Periodic review 2018 (PR18) working paper on the Volume Incentive**

**25 January 2018**

**Executive Summary**

1. We welcome the opportunity to respond to ORR's PR18 working paper on the Volume Incentive. We answer ORR's questions in turn, below. However, first we summarise our position on the key issues.

2. Our recent response to ORR's consultation on infrastructure cost charges (ICC) highlighted that we support being financially incentivised to accommodate additional trains on the network. However, ORR's decision to remove the Capacity Charge in CP6, coupled with the potential removal of the Volume Incentive (VI), could significantly reduce the financial incentives on Network Rail to accommodate additional trains on the network in CP6. In fact, this could mean that Network Rail is worse-off, financially, from accommodating additional traffic on the network.

3. Separately, ORR has proposed making changes to fixed charges in CP6 which could seek to duplicate the purpose of the VI. If implemented appropriately, ORR's proposed ICC could provide Network Rail with increased revenue when train operators run additional trains. However, the increase in revenue from additional freight trains is likely to be minimal because of the need for ORR to apply an affordability test to such payments. Combined with the removal of the Capacity Charge, capped Variable Usage Charge rates and the potential removal of the VI, the financial incentive on geographic routes to grow freight traffic could be adversely impacted in CP6. It is important that ways are considered to mitigate this risk.

4. In respect of the current VI, Network Rail does not receive (or make) any payment until the start of the next control period, which is made through an adjustment to Network Rail's revenue requirement. We consider that this payment mechanism limits the effectiveness of the VI because of the significant delay between action and financial consequence. This is even more relevant given the fixed SOFA funding envelope from government for CP6. Any VI payments at the start of CP6 (for CP5 VI performance) would require funding to be redirected from operations, maintenance and renewals expenditure. We consider that, because of this, the financial incentive on Network Rail to grow traffic during the control period has been neutralised and therefore the VI is no longer an effective financial incentive mechanism.

5. We agree with ORR that the current VI appears to be ineffective as a financial incentive, particularly given the way in which Network Rail is now funded. Therefore, we support ORR's emerging proposal to remove the VI in CP6 and replace it with an alternative mechanism. We agree with ORR that we should continue to report traffic growth at route-level through the regulatory accounts. In addition, we propose that passenger and freight traffic growth should also be reported on the CP6 route comparability scorecard. We consider that this will provide greater transparency around the accommodation of new train services across the network.

6. We consider that whatever ORR's decides with regards to the VI for CP6, the passenger and freight traffic growth forecasts should be realistic. By this we mean that they should be based on the 'base' railway plus traffic associated with schemes that are already taking place.

7. The remainder of this response provides detailed answers to each of the questions set out in ORR's working paper. We do not consider any part of this response to be confidential.

**Question 1: Do you think the volume incentive has made a significant contribution in CP5 to Network Rail's incentives to add services to the network?**

We have previously stressed the importance of the need for an effective mechanism that incentivises traffic growth. The VI was introduced to encourage Network Rail to grow rail traffic, by awarding us with a 'profit' on top of charges to train operators to recover the extra cost associated with additional train services. If we exceed the traffic growth baselines for the control period, we should receive extra money as part of the overall regulatory settlement at the beginning of the next control period (or less money if we do not meet the traffic growth baselines). In addition to the introduction of a downside to the VI in CP5, changes were also made to disaggregate the network-level baselines to route-level against which Network Rail reports annually in its Regulatory Accounts.

We do not consider VI to be an effective mechanism to incentivise Network Rail to grow traffic for the following reasons:

i. The VI does not drive routes' decision-making.

   As discussed in ORR's working paper, Network Rail carried out an informal, internal review to understand the extent to which the VI drives behaviours. These discussions suggested that the reputational and performance impact (i.e. Schedule 8) of introducing new services are far bigger drivers in routes' decision making than the VI. Since VI payments do not 'bite' until the beginning of the next control period and have a relatively low financial value, the general view was that the VI does not influence decisions around accommodating additional train services on the network.

ii. VI payments are delayed until the next control period.

   As discussed, above, the VI payment method is also considered to be a key issue limiting its effectiveness. For the VI to have an impact on behaviour, we consider that payment would need to be made at the time of introducing a new service. However, we recognise that receiving extra income from government during CP6 for accommodating additional train services is unlikely, given the fixed nature of DfT budgets for CP6.

iii. Changes to Network Rail's funding arrangements mean that funding may have to be extracted from other activities.

   Issues around the current payment mechanism are further compounded by the way in which Network Rail now receives funding from government. Any adjustments to the revenue requirement as a result of VI performance in the previous control period will likely be balanced out elsewhere in Network Rail's overall funding settlement. For example, for Network Rail to receive its VI payment, funding would have to be diverted from other areas such as operations, maintenance and renewals expenditure. Therefore, this does not result in 'additional' (or less) money overall for Network Rail, as has been the case in previous control periods.

iv. Other criteria are considered more important than the VI.

   Network Rail's Sale of Access Rights (SoAR) panel (as referenced in Figure A1 of ORR's VI working paper) requires that geographic routes, the Freight and National Passenger Operator route (FNPO) and the System Operator must follow specific criteria when considering requests to run additional traffic on the network. These consist of whether the proposed new service can be timetabled; whether they pose a risk to safety; whether the relevant area of the network is congested; and whether all relevant routes have been consulted. While the financial impact of an additional service is considered (which includes an estimate of any additional income resulting from the VI), the SoAR process places much more emphasis on these criteria.

In summary, we consider that the VI has made little contribution in CP5 to our incentives to add services to the network. In particular, there are more important considerations such as whether the additional services will have a detrimental effect on the timetable through increased delays. Also, the changes to the way in which Network Rail is funded during CP5 mean that the financial incentive on Network Rail to grow traffic during the control period has been neutralised.

**Question 2: Which of the three high-level options we have set out above do you think we should take forward? Could you explain your main reasons for supporting this option?**

We support ORR's option 2 (to remove the volume incentive in CP6 and replace it with an alternative mechanism). We support the removal of the VI for the reasons outlines above, and set out specific details relating to the possible implementation of an alternative mechanism, below.

*Traffic growth reporting mechanism*

We support ORR's proposal to continue to record traffic volume growth relative to a traffic growth forecast. This forecast should be based on the 'base' railway plus traffic associated with schemes that are already taking place.

We propose that passenger and freight traffic growth performance is reported on a geographic route basis as part of the route comparability scorecard, with national freight traffic growth performance also being reported on the FNPO route scorecard. We consider that the inclusion of traffic growth reporting metrics on the route comparability scorecard will increase visibility and help facilitate further discussions about traffic growth performance between all routes and customers.

Discussions between Network Rail, ORR and industry are ongoing about how the route comparability scorecard will ultimately work, in particular governance arrangements and the most appropriate methodology to compare route performance across each of the measures. For example, in respect of reporting traffic volume growth on the scorecards, we are keen to work with ORR to discuss whether traffic forecasts are set for the control period or on an annual basis.

We also note that there is industry interest in an overall 'railway system' dashboard which could include a traffic volume measure (along with other measures such as train performance). We consider that the System Operator would be best placed to coordinate this.

*Reporting metrics*

The CP5 VI consists of four metrics. There are two measures for passenger (passenger train miles and passenger farebox revenue) and two measures for freight (freight train miles and freight gross tonne miles). As stated in our response to ORR's July 2017 route requirements and scorecards consultation, we consider that the number of reporting metrics to include on the geographic and freight route comparability scorecards should be reduced to two. This would be a useful simplification compared with the current VI arrangements.

We consider that the reporting metrics for passenger and freight traffic growth should be passenger train miles and net tonne miles respectively. As we have previously set out, we consider that passenger train miles is a better measure of passenger traffic growth compared with passenger farebox revenue. This is because Network Rail has very limited influence over passenger farebox revenue and does not control the data. In respect of the freight metric, we consider that reporting growth in net tonne miles would provide better information on how freight trains are efficiently using the network (since freight trains should be running and filled to capacity). We also understand that reporting of net tonne miles is more closely aligned to what our freight customers would like to see measured.

*Calculating the economic and social value of traffic growth*

We note that ORR is considering whether to continue to calculate the social and economic value of accommodating additional growth in an alternative to the Volume Incentive. We are not clear on what the benefit would be of including an estimate of this in the traffic growth reporting that may replace the Volume Incentive (especially since a comprehensive calculation would be complex meaning that it would be of limited value, and would not result in any ‘physical’ payment). However, we note that the System Operator is likely to calculate the social and economic benefits of some specific changes in services, for example as part of business case development.

We consider that it would be more effective to focus on the implementation of a transparent reporting mechanism. This should be easy to understand and generate meaningful discussions between routes and customers about effective use of the network.

*Financial incentives to grow freight traffic*

With the removal of the Capacity Charge, and the potential removal of the Volume Incentive, the financial incentive on geographic routes to grow freight traffic will be adversely impacted in CP6. ORR is also considering introducing a new Infrastructure Cost Charge (ICC) as a mark-up on the Variable Usage Charge, to help pay for our fixed costs. However, for freight operators the ICC is likely to be capped to reflect the limited ability of freight operators to afford such a charge.

Following our response to ORR’s ICC consultation, we have developed our thinking on this issue further. The net effect of these changes could mean that Network Rail has very little financial incentive to run additional freight trains in CP6. In fact, we could experience a financial loss in running additional freight trains. We are concerned, in particular, that these changes could inadvertently lead to routes being financially incentivised to run additional passenger trains as opposed to freight trains. This would be an unsatisfactory situation. Therefore, we think that ways should be considered to mitigate this.

One option could be reporting traffic growth on the route comparability and FNPO scorecards which we discuss, above. Another option could be to develop a Network Rail mechanism whereby any additional route income earned through the ICC, following the introduction of additional train services, could be ‘pooled’ centrally and reallocated to routes based on all traffic growth (i.e. passenger and freight traffic). This would mean routes would be financially rewarded based on all traffic growth and would aim to rebalance geographic routes’ financial incentives to grow both passenger and freight traffic. However, this could reduce the incentive properties as the value of traffic growth to each route would be less predictable. We are keen to explore these ideas and practicalities with stakeholders.

At this stage, it is unclear what ORR will conclude with regards to the ICC. Therefore, it could be the case that our concerns with regards to financial incentives to grow freight traffic could also apply to some or all passenger traffic as well. It is important that we work closely on this issue with stakeholders and ORR.

**Question 3: If you think we should take forward option 1 (retain the existing mechanism), do you have any views on the current design of the volume incentive, and how it could be improved going forward?**

For the reasons discussed in question 1, above, we do not support retaining the existing mechanism. If ORR were to conclude that option 1 should be taken forward, however, there are a number of important changes that we consider need to be made:

- *Simplification:* we consider that the number of reporting metrics needs to be reduced from four to two (passenger train miles and freight net tonne miles), for the reasons discussed in our response to question 2, above.
- *Realistic forecasts:* a 'business as usual' traffic growth forecast should be used so that we have a reasonable expectation of outperforming the traffic growth target. By 'business as usual' we mean that it should be forecast on the 'base' railway plus traffic associated with schemes that are already taking place. Unrealistic and hard to achieve baselines could have the effect of neutralising the incentive if routes do not meet their target in year one. Routes would then not be able to catch up from year one and could become desensitised to the mechanism.
- *VI payment rates:* the payment rates for the VI mechanism should be increased. This would increase the visibility of the VI to routes, increasing, therefore, its financial impact.
- *VI payments during the control period:* as previously discussed, we consider that the most important change would be for VI payments to be made during the control period. This would significantly improve the VI's incentive properties. As discussed earlier, we recognise that a change of this nature would be extremely unlikely given the nature of our current funding arrangements with government.

**Question 4: Do you think there are potential reputational incentives from Network Rail continuing to report on its performance against the volume metrics used to calculate the volume incentive, even if the financial aspect is removed?**

We consider that reporting traffic growth on the route comparability and FNPO scorecards as well as continued reporting in the annual Regulatory Accounts would provide increased visibility of traffic growth across our network. In particular, this would create a more joined-up view to operators and routes on how Network Rail routes are increasing traffic growth across the network. We propose that the route comparability scorecard will be a key input to the vertical and horizontal governance meetings that are part of our matrix organisation governance structure. We recognise the value of healthy competition and believe using our route comparison scorecard throughout our governance framework will create internal reputational incentives that can create a competitive dynamic between routes, in order to drive improvement.

Increased visibility and the potential for comparison could result in increased reputational incentives on Network Rail to grow traffic. However, as discussed in our response to ORR's July 2017 route requirements and scorecards consultation, care should be taken in the extent to which comparisons between different routes can be made. There are a number of factors which vary across routes (e.g. how 'full' a route is, enhancement delivery and economic factors) which would need to be normalised for any meaningful comparison to take place. In addition, the operation of train services is rarely confined to just one geographic route and it would be important to understand how multi-route traffic would be taken account of as part of any route comparisons.

**Question 5: If you think we should take forward option 2 (remove the volume incentive in CP6 and replace it with an alternative mechanism), do you have ideas for additional changes that we should consider to improve the balance of incentives?**

As stated, above, we support ORR's proposal to take forward option 2 (although we do not consider that the continued calculation of the economic and social value of additional traffic growth for the purposes of traffic growth reporting is required as we are unclear on what the benefit would be and the complexity would be likely to limit its effectiveness).

ORR's working paper refers to its recent ICC consultation and making the fixed costs that franchised passenger operators pay responsive to changes in traffic. If implemented, we consider that ORR's proposed changes to fixed cost charges would effectively duplicate what the VI seeks to do (as well as providing for payment during the control period, unlike the current VI) and would therefore be consistent with VI's removal in CP6.

Network Rail's response to ORR's ICC consultation states that any mechanism that ORR proposes would ideally be asymmetric with the downside risk that we face being limited, reflecting our very limited ability to reduce our fixed costs if traffic levels fall. Our response also stresses the importance of using a 'business as usual' traffic growth forecast for which there is a reasonable expectation of outperformance. It also proposes that the charges would, ideally, be limited to a small proportion of our fixed cost base.

As discussed in our response to question 2, above, the potential removal of the Volume Incentive combined with other changes to freight operator charges in CP6, would be likely to impact the balance of financial incentives on geographic routes to grow passenger and freight traffic. Ways should be considered to address this issue, such that financial incentives are not be skewed towards one type of traffic.

Natasha Frawley
ORR
One Kemble Street,
London,
WC2B 4AN

Date: 15th December 2017

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Dear Natasha,

**PR18 working paper: The volume incentive**

Thank you for the opportunity to respond to the above working paper. Nexus leads on behalf of the North East Combined Authority (NECA) on Heavy Rail matters through the North East Rail Management Unit (NERMU). The Unit also includes the representatives of the Tees Valley Combined Authority.

NECA is generally supportive of the ORR suggested approach to 'Remove the volume incentive in CP6 and replace it with an alternative mechanism'.

From the industry evidences referred to in the paper and ORR own observations is does not seem appropriate to continue with the current arrangements, which no one seems to agree has been the most effective.

With the changes to the structure of Network Rail and the changes to future track and train partnerships it seems that other factors will incentive Network Rail to seek to accommodate unpredicted demand for additional capacity.

Turning to the specific questions posed in the working paper NECA responses are provided below:

1. Do you think the volume incentive has made a significant contribution in CP5 to Network Rail's incentives to add services to the network?

   On the evidence presented in the papers NECA considers that the volume incentive has had a marginal impact at best and does not seem to be a driving factor when considering access applications.

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2. Which of the three high level options we have set out above do you think we should take forward? Could you explain your main reasons for supporting this option?

   NECA would suggest that ORR takes forward option 2 (remove the volume incentive in CP6 and replace it with an alternative mechanism). The main reason for this is although the reshaping of Network Rail and future franchises should provide their own incentives it would be helpful for wider understanding and transparency to include measures as suggested in the paper to record the economic and social benefits of accommodating additional growth.

   NECA is also exploring devolution of franchising and management of local rail services in the North East, as well as closer integration of local rail services with our own metro system. Part of this Metro and Local Rail Futures exploration is to look at bringing back into use a number of disused lines / alignments. Our vision for future service specification is likely to include increased service frequency on these routes as well as on upgraded existing infrastructure. This vision, aimed at achieving local and economic growth, will be all the more achievable in a climate where Network Rail are incentivised to enable reasonable frequency enhancements. It is our clear view that such changes should not create unnecessary risk or costs on devolved franchising authorities or the franchisees running these services.

3. If you think we should take forward option 1(retain the existing mechanism), do you have any views on the current design of the volume incentive, and how it could be improved going forward?

   NECA suggest option 2 is taken forward.

4. Do you think there are potential reputational incentives from Network Rail continuing to report on its performance against the volume metric used to calculate the volume incentive, even if financial aspect is removed?

   Comparison against baseline capacity data is a useful metric to monitor but it is unlikely that this alone would have any reputational incentive on Network Rail.

5. If you think we should take forward option 2 (remove the volume incentive in CP6 and replace it with an alternative mechanism), do you have any

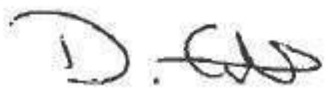
ideas for additional changes that we should consider to improve the balance of incentives?

I am afraid that NECA do not have any suggestions in this area.

Thank you for your consideration of these comments and hope you find them useful.

Should you require any further information, please do not hesitate to contact me.

Yours Sincerely



**<u>Derek Gittins – Head of Heavy Rail</u>**

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# Rail Delivery Group

Response to

## ORR's Working paper 6: The volume incentive

**Date: 25 January 2018**

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# Rail Delivery Group response to ORR's Working paper 6: The volume incentive

**Organisation**: Rail Delivery Group

**Address**: 200 Aldersgate Street, London EC1A 4HD

Business representative organisation

**Introduction**: The Rail Delivery Group (RDG) was established in May 2011. It brings together Network Rail and passenger and freight train operating companies to lead and enable improvements in the railway. The purpose of the RDG is to enable Network Rail and passenger and freight train operating companies to succeed by delivering better services for their customers. Ultimately this benefits taxpayers and the economy. We aim to meet the needs of:

- Our Members, by enabling them to deliver better outcomes for customers and the country;
- Government and regulators, by developing strategy, informing policy and confronting difficult decisions on choices, and
- Rail and non-rail users, by improving customer experience and building public trust

For enquiries regarding this consultation response, please contact:


**Tom Wood**

[redacted]

Rail Delivery Group

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London EC1A 4HD

1. This document outlines the key points from our members in response to the ORR's consultation on *Working paper 6: The volume incentive*. We are content for this response to be published on the ORR website.

Q1. *Do you think the volume incentive has made a significant contribution in CP5 to Network Rail's incentives to add services to the network?*

2. We do not think the volume incentive has made a significant contribution to Network Rail's incentives to increase services. There are several reasons for this as follows:

   - Incentives to improve punctuality and other incentives (both financial and reputational) outweigh the incentive to grow traffic.

   - The current volume incentive mechanism is too complex and may not be well understood across all routes.

   - The baselines are set too high.

Q2. *Which of the three high-level options we have set out above do you think we should take forward? Could you explain your main reasons for supporting this option?*

3. We believe that Network Rail should be incentivised to make the most effective use of network capacity. There should continue to be an incentive on Network Rail to grow passenger and freight traffic in CP6, as a balance to incentives on reliability and punctuality. In our view, the current volume incentive mechanism should be revised to overcome the problems identified above.

4. There should be a more immediate and direct financial impact of additional services in comparison to the current mechanism, which only comes into effect at the end of the 5-year control period.

Q3 and Q5. *If you think we should take forward the option to continue with a volume incentive but to revise the mechanism, do you have any views on the current design of the volume incentive, and how it could be improved going forward?*

5. We consider that the mechanism should be simplified, which could be achieved by removing the passenger farebox and freight train miles metrics and retaining the passenger train miles and freight gross tonne miles metrics.

6. The baseline for reporting should not be an aggressive target, but rather we suggest that all growth compared to current traffic is counted in the mechanism so that any growth above the existing level is incentivised.

7. We would support a stronger incentive whereby payments were made annually to each Route, hence as soon after the new traffic starts as possible. If traffic falls then that should not lead to an immediate reduction in Network Rail's funding.

8. We suggest that the System Operator takes more responsibility for facilitating growth by reporting the revised mechanism (disaggregated by route) on the SO scorecards for CP6.

Q4. *Do you think there are potential reputational incentives from Network Rail continuing to report on its performance against the volume metrics used to calculate the volume incentive, even if the financial aspect is removed?*

9. There are reputational incentives from reporting volume metrics but we believe they are relatively weak. As noted above, we would support an arrangement under which Network Rail is able to achieve an in-year financial reward for growing traffic above the baseline. However, we do recognise the financial constraints associated with Network Rail's fixed funding arrangements could make this challenging to implement. There should be a passenger and freight traffic growth metric on the System Operator scorecards for CP6 to help emphasise the importance of growth.

**Office of Rail and Road**

natasha.frawley@orr.gsi.gov.uk

25th January 2018

Dear Sir / Madam

**Re: Working Paper 6: The Volume Incentive**

Thank you for the opportunity to contribute to this consultation.

Tarmac, a CRH company, is the UK's leading sustainable building materials and construction solutions business. Our innovative services and solutions help to deliver the infrastructure needed to grow the economy today and create a more sustainable built environment to support our future prosperity. We employ approximately 7,000 people at more than 350 operational locations across the UK and are the largest manufacturer of cement and lime with facilities based in England, Wales and Scotland.

**General Comments**

Tarmac has invested significantly over many years in increasing its rail capability and is looking for further opportunities to do so. The benefits of bulk rail transport include lower $CO_2$ per tonne transported and removal of HGV movements from public highways, with one aggregate train removing up to 60 HGVs from the road. Rail freight also has far lower $NO_2$ and particulates emissions.

The rail network needs to be optimised and developed further to realise increased economic and infrastructure development benefits, not limited to passenger movements, which would result in significant damage to development of infrastructure and the economy. The rail freight network and mineral product handling facilities such as rail depots need to be safeguarded from competing uses such as passenger trains and housing developments. A strategic and stable mineral product supply chain is needed to achieve any long term infrastructure plan.

Construction activity by rail is increasing year on year but the increase in traffic is often in areas of congested network, for example, city centres and along main freight routes. Under the current arrangements it can be very difficult to review how different economic models might be used for running trains, in particular how journey times and path availability affects our ability to run the trains economically.

Tarmac needs additional freight capacity to increase low-carbon transport of construction materials into developing urban areas and other key locations. Network

Rail should be incentivised to provide quality rail freight capacity in the form of additional freight paths or improvements to existing paths. The average speed of a Tarmac loaded train is currently 16mph because of the network paths, despite assets capable of doing at least 60mph. The relationship and interaction between the FNPO (virtual freight) and geographical routes also needs to be improved so that the geographical routes are more positively encouraged to grow freight capacity and actual volume. This robust target for growth is more important if plans for joining “track and train” are taken forward.

Annex A of working paper 6 shows a growth target for freight set by HLOS in Scotland. Tarmac supports this target and suggests the same target-setting idea in the rest of the UK could result in the increased capacity required.

I hope that you find the above comments of interest and use. If you do have any questions resulting from the above, or would like to discuss the points raised in more detail, then please do not hesitate to contact me.

Yours faithfully,

**Chris Swan**
**Head of Rail**

Transport for London

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[redacted]

24 January 2018

Dear Natasha,

**PR18 Working Paper: The volume incentive**

This letter sets out TfL's responses to the questions raised in the ORR's consultation on the volume incentive. TfL is content for its responses to be published and shared with Third Parties.

1. **Do you think the volume incentive has made a significant contribution in CP5 to Network Rail's incentives to add services to the network?**

   TfL's experience is that adding traffic to the network to meeting growing passenger demand is a lengthy process requiring a significant time and often a financial input from TfL and the relevant operator in order to secure access rights. We have not seen evidence of the volume incentive working to incentivise NR to accept additional services.

2. **Which of the three high-level options we have set out above do you think we should take forward? Could you explain your main reasons for supporting this option?**

   We believe that the volume incentive should be removed on the basis of a lack of evidence in its effectiveness and the weakened incentive created by the change in NR's financial status. The focus should be on timetabling and use of infrastructure charges to deliver the most effective use of scarce network capacity by both passenger and freight operators. For example, charging operators for unused paths would help to incentivise more efficient use of capacity.

3. **If you think we should take forward option 1 (retain the existing mechanism), do you have any views on the current design of the volume incentive, and how it could be improved going forward?**

   Not applicable

4. **Do you think there are potential reputational incentives from Network Rail continuing to report on its performance against the volume metrics used to calculate the volume incentive, even if the financial aspect is removed?**

   We do not believe that there are reputational incentives from Network Rail continuing to report against the volume metrics so would not support option 2.

5. **If you think we should take forward option 2 (remove the volume incentive in CP6 and replace it with an alternative mechanism), do you have ideas for additional changes that we should consider to improve the balance of incentives?**

   Please see response to Question 2.

Yours sincerely,

C.A.Smales

**Carol Smales**
**Rail Development Manager**
**Transport for London**