OFFICE OF RAIL REGULATION

Periodic review 2013

Aligning incentives:

Decisions on route-level efficiency benefit sharing (REBS) and train operator exposure to Network Rail's costs at a periodic review

December 2012

Office of Rail Regulation

Contents

Abbreviations and acronyms

Abbreviation / acronym	Meaning
ATOC	Association of Train Operating Companies
CP4	Control Period 4 (1 April 2009 – 31 March 2014)
CP5	Control Period 5 (1 April 2014 – 31 March 2019)
CP6	Control Period 6 (expected to run 1 April 2019 to 31 March 2024)
DfT	Department for Transport
EBSM	Efficiency benefit sharing mechanism
SOM&R	Network Rail's support, operating, maintenance and renewal expenditure
PR08	Periodic review 2008
PR13	Periodic review 2013
REBS	Route-level efficiency benefit sharing
RFG	Rail Freight Group
RVfM	McNulty Rail Value for Money Study

Executive summary

Purpose, background and scope

1. We are committed to ensuring that the rail industry delivers a high quality service to passengers and freight customers in a way that delivers value for money for taxpayers and funders. The 2013 periodic review of Network Rail (PR13) is a key mechanism for securing these aims. PR13 will set Network Rail's outputs, funding and the wider regulatory and incentive framework from 1 April 2014 to 31 March 2019 (Control Period 5 (CP5)).

2. This document marks another important step in our periodic review. We set out our decisions in relation to two regulatory mechanisms that we could introduce in CP5 to help to strengthen the alignment of incentives between Network Rail and train operators (passenger and freight) and reduce industry costs.

3. We have consulted extensively on these proposed regulatory mechanisms within PR13 (in May 2011, December 2011 and finally in May 2012)[1]. The decisions set out in this document form part of our wider PR13 framework of incentives which act on Network Rail to drive efficiency improvements across its cost base. These decisions will help to sharpen the incentives on Network Rail by increasing train operators' interest in its costs.

4. This document explains why we have decided to:

    (a) develop the existing efficiency benefit sharing mechanism (EBSM)[2] into a route-level efficiency benefit sharing (REBS) mechanism, so that in CP5 it:

        (i) operates at a Network Rail operating route level;

        (ii) provides train operators (passenger and freight) with capped upside (25% share) and downside (10% share) exposure to Network Rail's financial performance (which is largely driven by Network Rail's efficiency);

        (iii) has pay-outs which take into account efficiencies achieved in alliances; and

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[1] Each of these consultations is available on our website via the following links: May 2011 at http://www.rail-reg.gov.uk/pr13/consultations/orr013.php; December 2011 at http://www.rail-reg.gov.uk/pr13/consultations/orr020.php; and May 2012 at http://www.rail-reg.gov.uk/pr13/consultations/orr021.php.

[2] In CP4, if Network Rail performs better than our PR08 assumptions, under the EBSM, train and freight operators share 25% of cumulative outperformance on a number of elements of expenditure and income with each operator receiving a pay-out in proportion to their variable track access charges. The EBSM is designed to operate at the national level with separate schemes for England & Wales and Scotland.

(iv) provides all train operators with an opt-out from the mechanism at the beginning of the control period,

(b) ask franchise authorities to expose new franchised train operators to changes in Network Rail's variable usage charge (from which they are currently 'held harmless' in their franchise contracts), for future control periods, rather than developing a new regulatory mechanism, as we proposed in May 2012, to increase train operators' exposure to Network Rail's costs at a periodic review. We will also work with the governments to explore how we can increase franchised train operators' exposure to the fixed charge and to changes in it.

5. We are setting out these decisions now to help the industry factor them into its plans. This should provide the industry with greater certainty and should also improve the effectiveness of the incentives. As we are setting out our decisions early in the periodic review, there are some aspects (e.g. how we will set REBS baselines and then monitor performance within CP5) that we cannot yet confirm[3]. We will consult on these issues in our draft PR13 determination (June 2013) and set out our decisions in our final determination (October 2013).

What we are trying to achieve

6. In a normal competitive market, when a company reduces its costs, its customers should benefit as a result of the lower prices or better service they receive. There are, therefore, normal market incentives in place for firms to work together with their suppliers to help reduce their suppliers' costs and for suppliers to encourage them to do so. In the rail industry these normal market incentives are not effective, primarily because franchise agreements provide franchisees with a high degree of protection against the financial impact of changes to access charges that we make at a periodic review[4]. These protections are not in place for open access operators (passenger and freight), but these operators account for less than 2% of Network Rail's income and 8% of traffic.

7. We want to see the relationships between Network Rail and its customers (train operators) put on a more commercial footing, i.e. becoming one in which Network Rail's customers are exposed to changes in Network Rail's costs (through the charging framework) and thereby face an incentive to help the company to reduce them. There are already cases where train operators are fully exposed to costs, e.g. traction electricity costs and open access operators' exposure to changes in variable charges. This exposure has led those train operators to put

[3] We want our approach to the measurement of performance for REBS to be consistent with our general approach to efficiency reporting for Network Rail in CP5, which we are consulting on in our draft PR13 determination.

[4] There are also other factors including the significant proportion of Network Rail's income (64%in 2011-12) that comes directly from government grants.

considerable effort into investigating and challenging Network Rail's costs and efficiency in those areas. However, these arrangements currently only cover a very small proportion of Network Rail's total cost base and we are keen to see the level of engagement and challenge that these operators bring extended. There are substantial opportunities to expose franchised train operators to a higher proportion of Network Rail's cost base[5] and to reduce Network Rail's direct government support[6].

8. We are committed to improving value for money in the rail industry and are challenging the industry to realise substantial cost savings. The Rail Value for Money (RVfM) study[7] led by Sir Roy McNulty, which we commissioned jointly with the Department for Transport (DfT), has highlighted the value for money challenge facing the rail industry.

9. We consider (as did the RVfM Study) that strengthening the alignment of incentives between Network Rail and train operators is a key enabler for delivering industry savings. The RVfM Study estimated that better aligned incentives, through initiatives such as REBS and alliancing, could help to reduce annual industry costs by as much as £300m by the end of CP5 (i.e. 2018-19). Indeed, in the first three years of CP4 train operators have already helped Network Rail achieve more than £60m of cumulative outperformance, over and above our PR08 efficiency assumptions[8].

10. We recognise that REBS provides private sector companies, i.e. train operators, with the opportunity to receive short-term financial benefits in return for helping Network Rail to deliver long-term industry cost reductions. We think that the capped pay-outs under REBS represent good value for money in terms of the wider efficiencies they will generate by providing a stimulus for greater collaboration between Network Rail and the train operators. For example, EBSM pay-outs to train operators totalled £15.9m for the first three years of CP4 but the outperformance achieved is likely to generate significantly higher long-term savings for passengers, freight customers and funders[9]. Furthermore, although the focus of REBS is on outperformance, and participating train operators will receive financial rewards for contributing

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[5] Network Rail's expenditure in 2011-12 was £8.5bn.

[6] Network Rail receives approximately two thirds of its income directly from the governments. In 2011-12, Network Rail received £4.0bn in grant payments.

[7] The RVfM Study found that the GB rail industry should target a reduction in unit costs of 30% by 2018-19 compared to the annual industry costs in 2008-09. The RVfM Study's top-down approach estimated that, based on 2008-09 data, the industry's efficiency gap was £2.5bn to £3.5bn (in 2008-09 prices). In 2011-12 prices this is a gap of £2.7bn to £3.8bn.

[8] We determined the level of outperformance for EBSM in our 2011-12 annual efficiency and finance assessment, available at: http://www.rail-reg.gov.uk/upload/pdf/nr_annual_asessment_2011-12.pdf.

[9] To illustrate, if we assume Network Rail's outperformance in the first three years of CP4 (outperformance of £63.7m resulting in EBSM pay-outs of £15.9m) relates to recurring savings (i.e. that continue to provide benefit in the future, e.g. for 30 years), this could translate into long-term savings for funders of up to £1.7bn (not taking into account the time value of money).

to cost savings, they will also be at risk for a proportion of the costs resulting from any underperformance. It is not simply a 'no-lose' situation for train operators.

Options for improving alignment through regulatory mechanisms

11. Ultimately, we would like to see better alignment of incentives, through exposure of Network Rail's customers to its costs, achieved via more commercial arrangements for franchised passenger services and an access charging structure which is more cost-reflective and sends better signals for efficient provision and use of network capacity. Our decisions in this document have been made in the context of our longer-term vision for an industry in which more decisions on the delivery of the railway are taken by the industry itself with less detailed specification from regulation. We recognise that this vision will take time to achieve – building blocks need to be put in place and decisions will need to be taken by us and by other key industry stakeholders (e.g. governments)[10]. Our intention in CP5 is to take the steps that deliver real improvements for passengers, freight customers and funders in the short term while also moving us closer towards our vision in the long term. These PR13 decisions act as a 'stepping stone' towards achieving our longer-term vision.

12. We support the steps that the industry has already taken to improve alignment. Examples include Network Rail's move towards a management structure which is devolved to its operating routes and the creation of the 'deep' alliance[11] on the Wessex route[12]. We consider alliancing arrangements to be a key driver of industry cost savings, as they facilitate and incentivise more collaborative working between train operators and Network Rail.

13. As part of PR13, we have consulted on two specific sets of options which aim to address the issue of weak incentive alignment:

    (a) **developing the existing EBSM**: into a route-level mechanism, i.e. REBS, that would expose train operators to Network Rail's costs in each year of the control period; and

    (b) **exposing train operators to changes in Network Rail's costs at a periodic review**: a set of options that supports a more normal customer / supplier relationship by exposing customers (train operators) to their supplier's (Network Rail's) costs at future periodic reviews.

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[10] For example, some of these changes can only be made to franchises as they are re-let.

[11] In Network Rail's draft statement on alliances, it defines a 'deep' alliance as one in which one of Network Rail's routes (or potentially part of a route) and a train operator share upside or downside risk against an agreed baseline for all or most of their activities. Network Rail's statement is available at: http://www.networkrail.co.uk/WorkArea/DownloadAsset.aspx?id=30064780829.

[12] Our statement on alliancing, published in March 2012 is available at: http://www.rail-reg.gov.uk/server/show/ConWebDoc.10854.

14. Each of these approaches requires DfT and Transport Scotland to agree to make changes to franchise contracts. We note that the on-going review by Richard Brown of passenger franchising in England and Wales is looking at the risk to which train operators are exposed in franchises. And so, while we do not expect to change the decisions that we set out in this document, we will consider the implications of the Brown review (and government's response to them), and we will revise them if appropriate.

REBS

15. Following support for the principles of our proposed efficiency sharing mechanism, we have decided to build on the experience of the existing EBSM in CP4 and implement a revised mechanism in CP5 that will:

    (a) **operate at a Network Rail operating route level:** by developing EBSM so that it operates at a route level[13], this will strengthen the relationship between the effort of individual train operators to reduce Network Rail's costs and the pay-outs they receive;

    (b) **provide train operators with capped upside and downside exposure to Network Rail's performance:** caps limit the risk of windfall gains and losses for train operators whilst the upside/downside exposure incentivises train operators to work with Network Rail regardless of whether it is underperforming or outperforming our determination assumptions;

    (c) **include the performance of alliances:** this will support industry cost reductions as it provides incentives on Network Rail, the alliance partner, and secondary operators to support route-level cost savings, both inside and outside of alliance arrangements; and

    (d) **provide train operators with an opt-out from the mechanism (by route):** an opt-out provides train operators with the opportunity (but not the obligation) to enter into arrangements to share in Network Rail's performance. Network Rail, in recognition of its monopoly status, will be required to make REBS available to all train operators. Train operators that enter into REBS will have had the opportunity to evaluate the risks involved, i.e. they will have visibility of our determination and be able to assess the likelihood of outperformance and underperformance, and hence will be able to focus their efforts on reducing costs in areas where they have some influence. In our

[13] Network Rail's ten operating routes are: Anglia, East Midlands, Kent, London North Eastern, London North Western, Scotland, Sussex, Wales, Wessex and Western.

view, the efficiencies that operators could generate through better working with Network Rail will make the arrangement attractive.

16. We see REBS in CP5 as a stepping stone to the development of more commercial relationships within the industry. As our preference is for more commercial arrangements, we would be content to see train operators opting out of REBS to pursue their own commercially negotiated risk and reward sharing agreements with Network Rail, provided such arrangements were transparent and non-discriminatory. Indeed, we do not expect REBS to be a long-term regulatory mechanism, but think that it will act as a stimulus for a change in the behaviour of Network Rail and the train operators that will become self-sustaining in the longer term. As such, we will review whether the industry still requires a REBS mechanism for future control periods as part of our next periodic review.

Exposing train operators to changes in Network Rail's costs at a periodic review

17. Franchised train operators currently have weak incentives to engage with a periodic review because they are held neutral through their franchise contracts to changes in Network Rail's access charges, i.e. they do not benefit from lower regulated prices determined at a periodic review, nor are they exposed to increasing prices that would more accurately reflect the true costs of providing the infrastructure services that they use.

18. To complement our proposals on REBS, we have consulted on options which intend to support the creation of a more commercial customer / supplier relationship (between train operators and Network Rail). These policy options have broadly the same objective as REBS (i.e. to strengthen incentive alignment). But instead of incentivising within-control period efficiencies, they encourage train operators to engage with us and Network Rail during the periodic review process to drive down industry costs. Our most recent consultation (May 2012) set out two options which sought to achieve this objective:

    (a) **a regulatory mechanism:** develop a regulatory mechanism that would expose train operators to changes in Network Rail's costs arising from future periodic reviews, starting in CP6; or

    (b) **exposure to variable charges:** an alternative approach, which has the same objective as the regulatory mechanism, is to ask franchising authorities to provide new franchisees with exposure to cost-reflective changes[14] in Network Rail's track

[14] We are only intending to provide train operators with exposure to changes in access charges that are caused by analytical evidence on cost causation and efficiency, and not to the impact of changes that relate to different approaches to regulatory policy.

access charges (open access operators (passenger and freight) are already on risk for these charges)[15].

19. Considering our preferred direction of travel towards a more normal set of commercial relationships and less complex regulation, we think that there is a strong advantage in changing franchise contracts to expose train operators to a more appropriate level of risk – essentially removing a distortion in the current regime – over an additional regulatory mechanism that would be designed to compensate for that distortion.

20. The Brown review is exploring the scope for providing franchised train operators with greater exposure to changes in Network Rail's costs (i.e. wider than our initial proposal for the variable usage charge). As part of that review, we are arguing for greater franchise exposure to Network Rail's costs because we consider this to be aligned with our vision for a more commercial industry.

21. In our view, providing new franchises with exposure to cost-reflective changes in the variable usage charge would represent a significant step in the right direction and we are asking the governments to provide for this exposure in all new franchise contracts.

22. Given the proportion of Network Rail's costs that are recovered through the fixed charge, we think that exposing franchisees to the fixed charge would generate further efficiency savings, by giving franchised train operators a greater interest in challenging these costs and working with Network Rail to reduce them. As with exposure to the variable usage charge, this is ultimately a decision for the governments and so we will be working with them to explore how we can increase franchised train operators exposure to the fixed charge and to changes in it.

23. We recognise that this is a significant departure from existing industry arrangements and consider that further exposure to Network Rail's costs would be phased in over more than one control period (i.e. from CP6 onwards).

[15] It is important to note that this option is not within our gift, as it would be achieved through changes to new franchise contracts.

1. Introduction

Purpose of this document

1.1 This document marks another important step in the 2013 periodic review of Network Rail's access charges (PR13), which will set Network Rail's outputs, access charges and the wider regulatory and incentive framework for control period 5 (CP5) – which will run from 1 April 2014 to 31 March 2019.

1.2 We set out our decisions for PR13 in relation to strengthening the alignment of incentives between Network Rail and train operators (passenger and freight) to improve efficiency. These proposals are part of our wider PR13 framework of incentives which act on Network Rail to drive efficiency improvements across its cost base. These options sharpen the incentives on Network Rail by increasing train operators' interest in its costs.

1.3 We have consulted extensively on our PR13 proposals (in May 2011, December 2011 and finally in May 2012). This document reflects on the policy options that we have consulted on and sets out our decisions.

Timings of our decisions

1.4 We are setting out our decisions on this area of the PR13 incentives regime, in advance of our draft and final PR13 determinations. We are doing this because there are a number of passenger franchises that are due to be re-let before, and during, CP5 and by providing early clarity on our decisions, franchising authorities will have more time to incorporate the impact of our decisions into the bidding process, and bidders will have the opportunity to factor the impact of our decisions into their bids.

Scope

1.5 This document sets out our decisions on a number of key elements of the incentive framework, that will take effect at the beginning of CP5, in order to strengthen the alignment of incentives between Network Rail and train operators.

1.6 We are setting out our high level decisions on this area of the PR13 incentives framework now because we think that it is important to provide the industry with information on our decisions as soon as we can. As we are setting out our decisions early in the periodic review, there are some aspects of the route-level efficiency benefit sharing (REBS) design that we that we cannot yet confirm. As a result, this document does not cover the following decisions for CP5:

(a) the efficiency challenge that we are setting Network Rail in CP5;

(b) the process for setting REBS baselines and reporting performance against the baselines[16]; and

(c) the specific items of income and expenditure that will be included in REBS (although we set out our latest thinking on this in Chapter 4).

1.7 We will consult on these issues in our draft PR13 determination (June 2013) and set out our decisions on these issues in our final determination (October 2013).

Structure of this document

1.8 The rest of this document is structured as follows:

(a) Chapter 2 sets out the objectives of PR13 and the background to our decisions;

(b) Chapter 3 sets out our decisions on REBS; and

(c) Chapter 4 sets out our decisions on exposing train operators to changes in Network Rail's costs at a periodic review.

1.9 There are also two annexes:

(a) Annex A – Extent of financial exposure for train operators under REBS; and

(b) Annex B – Defining regulatory policy and technical changes in access charges.

[16] Although we have not decided on our approach to setting the REBS baseline in this document, we have written to Network Rail to explain the principles by which any approach should adhere. This letter is available at: http://www.rail-reg.gov.uk/pr13/consultations/orr021.php.

2. Background

Key messages
• Under the current franchise and regulatory framework, Network Rail's customers are to a large degree indifferent to its costs. • We consider that there is currently a weak alignment of incentives between Network Rail and train operators. The McNulty Rail Value for Money (RVfM) Study also highlighted this issue and considered it to be a significant barrier to industry reform. • Our vision is to move to a more 'commercial' relationship between Network Rail and its customers. • We have engaged extensively with the industry in consulting on our PR13 proposals to strengthen the alignment of incentives between Network Rail and train operators. • As part of PR13, we have consulted on two sets of options which aim to address the issue of weak incentive alignment. • Each of these approaches requires the Department for Transport (DfT) and Transport Scotland to agree to make changes to franchise contracts.

Purpose

2.1 The purpose of this chapter is to provide some background to this document, including:

(a) an overview of PR13;

(b) a description of what we are trying to achieve;

(c) our approach to aligning incentives in PR08;

(d) the options available to us for improving alignment; and

(e) how our decisions can help us meet our longer-term objectives.

Overview of PR13

2.2 Our objective for PR13, as set out in our ' Periodic review 2013: setting the financial and incentive framework for Network Rail in CP5' document, published in May 2012[17] – is to protect the interests of customers and taxpayers by:

"ensuring our determination enables Network Rail and its industry partners to deliver or exceed all the specified outcome and output requirements safely and sustainably at the most efficient levels possible comparable with the best railways in the world by the end of the control period."

[17] This document is available at: http://www.rail-reg.gov.uk/pr13/publications/financial-incentives.php.

2.3 A key aim of any regulatory price control is to ensure that the regulated company (in this case, Network Rail) is as efficient as possible given the obligations on the company and wider circumstances. In the context of the railway, this means maximising value for customers and funders. To achieve this, industry reform will be crucial. In our advice to ministers[18] we said that we saw PR13 as an important facilitator and driver of industry reform – in particular through our key transformational goals:

(a) a clear focus on what matters to passengers, freight customers and funders – particularly improving value for money;

(b) a more disaggregated approach – increasing transparency and access to information, facilitating greater localism, and supporting more disaggregation in the industry (for example through Network Rail devolution) will provide for a more comparative approach to regulation and a better understanding of costs, income and subsidy across the sector;

(c) alignment of incentives – improving the interfaces between the different players in the industry, for example, by facilitating alliances and REBS where these improve whole sector working, will drive greater value for money for customers and funders; and

(d) greater contestability and more effective competition – ensuring that there is more effective use of market mechanisms through the value chain delivering further efficiencies.

What we are trying to achieve

2.4 In a normal competitive market, when a company reduces its costs, its customers should benefit as a result of the lower prices or better service they receive. There are, therefore, normal market incentives in place for firms to work together with their suppliers to help reduce their suppliers' costs and for suppliers to encourage them to do so. In the rail industry these normal market incentives are not effective. Principally, this is because:

(a) 25% of Network Rail's income and 92% of its traffic comes from franchised passenger train operators[19]. Only 1% and 7% respectively comes from freight operators and only 0.4% and 1% respectively from open access passenger operators[20];

[18] This letter is available at: http://www.rail-reg.gov.uk/pr13/consultations/orr021.php.

[19] This excludes stations and depots income.

[20] Income figures are based on Network Rail's 2011-12 regulatory accounts and traffic information is based on Network Rail data on train miles.

(b) under the financial adjustment mechanism (Schedule 9/Clause 18.1) in franchise agreements, franchised operators have a high degree of protection against the financial impact of changes to access charges that we make at a periodic review (relating to changes in Network Rail's costs);

(c) charges paid by open access operators (passenger and freight) cover only costs directly incurred. Our current structure of charges, which is in line with European law, is such that the variable usage charge covers only the cost of wear and tear generated by trains running on the tracks; and

(d) fixed track access charges are paid by franchised train operators, but constitute only 14% of Network Rail's overall revenue requirement. Governments pay 64% of the company's total income in the form of a network grant, in lieu of fixed charges.

2.5 We want to see the relationships between Network Rail and its customers (train operators) put on a more commercial footing, i.e. becoming one in which Network Rail's customers are exposed to more of Network Rail's costs (through the charging framework) and thereby face an incentive to help the company to reduce them. There are already cases where train operators are fully exposed to costs, e.g. traction electricity costs and open access operators' exposure to changes in variable charges. This exposure has led those train operators to put considerable effort into investigating and challenging Network Rail's costs and efficiency in those areas. However, these arrangements currently only cover a very small proportion of Network Rail's total cost base and we are keen to see the level of engagement and challenge that these operators bring extended. There are substantial opportunities to expose franchised train operators to a higher proportion of Network Rail's cost base[21] and to reduce Network Rail's direct government support[22].

2.6 Train operators engage with Network Rail on a daily basis on operational and planning issues. We consider that an alignment of incentives through greater exposure to Network Rail's costs would increase Network Rail's efficiency because train operators:

(a) have access to information regarding Network Rail's working practices and costs. They could therefore challenge Network Rail directly, giving it less scope to live the 'quiet life' of a monopolist;

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[21] Network Rail's expenditure in 2011-12 was £8.5bn.

[22] Network Rail receives approximately two thirds of its income directly from the governments. In 2011-12, Network Rail received £4.0bn in grant payments.

(b) could share their observations with us. Using this additional information, we would be able to regulate Network Rail more effectively, for example by seeing further scope for efficiency challenge;

(c) could cooperate with Network Rail to save costs, for example by agreeing on specific access arrangements (including possessions) or by sharing resources that are duplicated; and

(d) could advise on the scope and timing of renewals projects, ensuring that they are not over specified or otherwise more expensive than they need to be, and that the needs of passengers and freight customers are better taken into account in planning, all directed at delivering better value for money.

2.7 We are committed to improving value for money in the rail industry and are challenging the industry to realise substantial cost savings. The Rail Value for Money (RVfM) study[23] led by Sir Roy McNulty, which we commissioned jointly with the Department for Transport (DfT), has highlighted the value for money challenge facing the rail industry.

2.8 We consider (as did the RVfM Study) that strengthening the alignment of incentives between Network Rail and train operators is a key enabler for delivering industry savings. The RVfM Study estimated that better aligned incentives, through initiatives such as REBS and alliancing, could help to reduce annual industry costs by as much as £300m by the end of CP5 (i.e. 2018-19). Indeed, in the first three years of CP4 train operators have already helped Network Rail achieve more than £60m of cumulative outperformance, over and above our PR08 efficiency assumptions[24].

2.9 We recognise that REBS provides private sector companies, i.e. train operators, with the opportunity to receive short-term financial benefits in return for helping Network Rail to deliver long-term industry cost reductions. We think that the capped pay-outs under REBS represent good value for money in terms of the wider efficiencies they will generate by providing a stimulus for greater collaboration between Network Rail and the train operators. For example, EBSM pay-outs to train operators totalled £15.9m for the first three years of CP4 but the outperformance achieved is likely to generate significantly higher long-term savings for passengers, freight customers and funders[25]. Furthermore, although the focus of

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[23] The RVfM Study found that the GB rail industry should target a reduction in unit costs of 30% by 2018-19 compared to the annual industry costs in 2008-09. The RVfM Study's top-down approach estimated that, based on 2008-09 data, the industry's efficiency gap was £2.5bn to £3.5bn (in 2008-09 prices). In 2011-12 prices this is a gap of £2.7bn to £3.8bn.

[24] We determined the level of outperformance for EBSM in our 2011-12 annual efficiency and finance assessment, available at: http://www.rail-reg.gov.uk/upload/pdf/nr_annual_asessment_2011-12.pdf.

[25] To illustrate, if we assume Network Rail's outperformance in the first three years of CP4 (outperformance of £63.7m resulting in EBSM pay-outs of £15.9m) relates to recurring savings (i.e. that continue to provide benefit in the future, e.g.

REBS is on outperformance, and participating train operators will receive financial rewards for contributing to cost savings, they will also be at risk for a proportion of the costs resulting from any underperformance. It is not simply a 'no-lose' situation for train operators.

Our approach in PR08

2.10 In PR08, we introduced an efficiency benefit sharing mechanism (EBSM) to help address the weak alignment of incentives between Network Rail and train operators for CP4. The aim of EBSM is to encourage train operators to work with Network Rail to reduce its costs and thus incentivise greater efficiency. EBSM provides for operators to share in a proportion of outperformance achieved by Network Rail.

2.11 We are, however, conscious that the effectiveness of EBSM could be improved. In particular:

(a) under Schedule 9/Clause 18.1, operators whose franchises were established prior to the PR08 determination do not retain payments from EBSM and therefore are not incentivised to work with Network Rail to reduce its costs; and

(b) as the mechanism is applied at a national level (in each of England & Wales and Scotland), there is a weak relationship between the effort of individual train operators and the pay-outs they may receive.

2.12 As documented in our annual efficiency and finance assessment 2011[26], we did not have sufficient confidence in Network Rail's reporting of renewals efficiencies to sanction EBSM payments in 2010-11. We now consider that Network Rail has made sufficient improvements to its reporting processes and as a result we have sanctioned EBSM payments for 2011-12. Our assessment of Network Rail's cumulative outperformance on the relevant elements of income and expenditure for the first three years of CP4 shows that EBSM payments to train and freight operators should be £2.7m in England & Wales and £13.2m in Scotland[27].

Options for improving alignment

2.13 As part of PR13, we have engaged extensively with the industry in consulting on our proposals to strengthen the alignment of incentives between Network Rail and train operators for CP5, and future control periods[28]. We have held, and attended, several industry

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for 30 years), this could translate into long-term savings for funders of up to £1.7bn (not taking into account the time value of money).

[26] Our annual efficiency and finance assessments are available at: http://www.rail-reg.gov.uk/server/show/nav.2050.

[27] DfT and Transport Scotland may seek to recover any EBSM payments where they are entitled to do so, for example, using the Clause 18.1 / Schedule 9 provisions in their franchise agreements. The minimum amount that may be retained by passenger and freight operators will be around £1.1m for England & Wales and £6.3m for Scotland. This has been calculated in proportion to operators' cumulative variable usage charges (separately for England & Wales and Scotland).

workshops on this topic, as well as numerous bilateral meetings with stakeholders to discuss their views on our proposals.

2.14 Ultimately, we see scope for better alignment of incentives achieved through the harnessing of commercial pressures. This could include:

(a) giving train operators stronger incentives to support and challenge Network Rail's efficiencies by making sure that they share in both upside and downside cost movements, which are reflected in changes to charges for use of the network; and

(b) a change to the structure of charges to improve cost reflectivity, recognising that the current 'fixed charge' actually includes elements of cost over which train operators have some influence, such as capacity usage, which could be charged for in a way that sends better signals for efficient provision and usage.

2.15 We have workstreams in place that will improve the structure of charges in PR13 (for example in relation to traction electricity costs and the freight specific charge) and we are working with the industry to establish a larger workstream designed to look more fundamentally at the structure of charges, reporting early in CP5.

2.16 As part of PR13, we consulted on two sets of options which aim to address the issue of weak incentive alignment:

(a) **developing the existing EBSM**: into a route-level efficiency benefit sharing (REBS) mechanism in CP5, that would expose train operators to Network Rail's costs in each year of the control period; and

(b) **exposing train operators to changes in Network Rail's costs at a periodic review:** another approach, which is complementary to REBS, to align the incentives of Network Rail and train operators and reduce Network Rail's costs by exposing train operators to those costs at future periodic reviews.

2.17 Each of these approaches requires DfT and Transport Scotland to agree to make changes to franchise contracts. On the basis of our discussions, we understand they are prepared to do so in the current franchising round, which makes these options feasible for PR13. We note that the on-going review by Richard Brown of passenger franchising in England and Wales is looking at the risk to which train operators are exposed in franchises. And so, while we do not expect to change the decisions that we set out in this document, we will consider the

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[28] We have published our proposals on strengthening the alignment of incentives between Network Rail and train operators in May 2011, December 2011 and May 2012. Each of these consultations is available on our website via the following links: May 2011 at http://www.rail-reg.gov.uk/pr13/consultations/orr013.php; December 2011 at http://www.rail-reg.gov.uk/pr13/consultations/orr020.php; and May 2012 at http://www.rail-reg.gov.uk/pr13/consultations/orr021.php.

implications of the Brown review (and government's response to them), and we will revise them if appropriate.

2.18 To inform our decisions, we have carried out our own analysis on the impact of our proposals on train operators, Network Rail and the governments. We also commissioned (jointly with ATOC) KPMG to carry out a study, focused mainly around the impact of REBS on train operators' finances[29].

2.19 The next two chapters explain our decisions in relation to the two sets of proposals.

[29] Annex A provides a summary of our analysis.

3. REBS

Key messages

- We have decided to revise the existing EBSM so that REBS in CP5 has the following characteristics:
  - out(under)performance calculated at the route-level;
  - train operators exposed to upside and downside risk;
  - REBS pay-outs include the impact of alliance performance; and
  - train operators able to opt-out of the mechanism at the beginning of the control period.
- There are some aspects of the REBS design that we are not yet able to conclude on, e.g. the process for setting the REBS baseline and reporting performance against these baselines. We will consult on these issues in our PR13 draft determination.

Purpose

3.1 The purpose of this chapter is to explain our decisions on a revised EBSM for CP5, including:

(a) the proposals that we have previously consulted on:

(b) responses to our consultations;

(c) our decisions on REBS; and

(d) further work to be completed prior to the start of CP5.

Background

3.2 We first consulted on our high level proposal to develop the existing EBSM in May 2011[30]. We proposed that a revised mechanism could function at the Network Rail operating route level (rather than on a national basis) so that the efforts of train operators are more closely aligned to the pay-outs they may receive via REBS.

3.3 The objective of REBS is to strengthen the alignment of incentives between Network Rail and train operators – through the development of a clear, simple and comprehensive default mechanism in CP5 for Network Rail to share efficiencies with train operators – in order to support greater co-operation to drive down industry costs.

[30] Our May 2011 consultation is available at: http://www.rail-reg.gov.uk/pr13/consultations/orr013.php.

3.4 In our PR13 incentives consultation, published in December 2011[31], we confirmed that we intended to develop our high-level REBS proposal and we set out:

(a) the principles to which we considered REBS should adhere;

(b) a more detailed proposal for the rules and parameters of REBS; and

(c) an illustrative analysis of the financial implications of our proposals[32].

3.5 In summary, we proposed that REBS would:

(a) be disaggregated to a route level. The mechanism would apply for each of Network Rail's routes;

(b) include downside risk. Unlike EBSM, we proposed that Network Rail also shares the cost of underperformance with train operators; and

(c) be the default option for all train operators (subject to some de minimis conditions[33]) and we would only accept alternative alliance arrangements if they adhered to our principles for REBS.

3.6 In May 2012, we published our final consultation on REBS in which we explained that we were minded to implement a REBS mechanism in CP5, as per our December 2011 proposals but that this was subject to clarifying our position on the interaction of REBS with alliances. We, therefore, consulted on whether: a) REBS pay-outs should be calculated, before considering alliance performance (REBS excluding alliances), or b) REBS pay-outs should be calculated including out(under)performance achieved within alliances (REBS including alliances).

Consultation responses

3.7 We summarised responses to our first two consultations in Annex A of our May 2012 consultation[34] and took them into account in reaching our view, as set out in that document, that we were minded to proceed with REBS. We have not provided a similar review of those responses in this document but we do summarise the responses to our May 2012 consultation below.

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[31] Our December 2011 consultation is available at: http://www.rail-reg.gov.uk/pr13/consultations/orr020.php.

[32] A summary of our analysis is presented in Annex A.

[33] The de minimis would allow an opt-out from REBS (for that route only) for train operators with low levels of traffic on an operating route.

[34] Our May 2012 consultation is available at: http://www.rail-reg.gov.uk/pr13/consultations/orr021.php.

Consultation responses – May 2012

3.8 Consultees' responses indicated a clear preference for the inclusion of alliance performance within REBS calculations but many train operators (passenger and freight) suggested that an opt-in / opt-out by route, at the beginning of the control period, would allow train operators to better manage risk. There were also mixed views about the level of assurance that we would need to provide over alliance activities.

3.9 DfT and Transport Scotland supported our proposal for REBS but asked us to resolve issues with efficiency measurement and interactions with alliancing. DfT's initial view was that REBS including alliance performance is the best approach to alliance interactions. Transport Scotland was supportive of REBS including alliance performance and thought that REBS should be the default where no bespoke arrangements are in place. Transport Scotland also suggested that we should look at an opt-out for minority operators and clearly define the criteria.

3.10 Network Rail continued to express its preference for alliances as a way of incentivising operators. However, it did agree that the option of REBS including alliance performance was the most appropriate approach for REBS as it considered that this incentivises all operators towards support for alliances and reduces perverse incentives to make and book performance to particular sides within the alliance. Network Rail also reconfirmed its support for including Schedule 4 and 8 within REBS baselines but excluding property income.

3.11 ATOC also preferred the option of REBS including alliance performance, recognising that all operators should share in the whole-industry benefit and encouraging support for alliance outcomes. This reflected the majority of passenger train operators' views. Freight operators such as DB Schenker, Freightliner and GB Railfreight reconfirmed their opposition to the proposed REBS design but supported the option of REBS including alliance performance, although Freightliner suggested that this option should only be chosen if REBS was upside-only.

Comments on consultation responses

3.12 We have considered these responses in reaching our decisions, which are set out below. Having regard to the key comments from consultees, we make the following points:

(a) we agree that commercial arrangements, such as alliances, should be the main drivers of strengthening incentive alignment between Network Rail and train operators. We do, however, think that REBS has an important role to play in CP5 in stimulating a change in the behaviour of Network Rail and the train operators in the longer term;

(b) we agree that the approach we take to Network Rail's efficiency reporting in CP5 will have a significant bearing on the success of REBS. This is why we have decided to incorporate our decision on the methodology for calculating REBS performance into our wider PR13 work on CP5 efficiency reporting. We will consult on this in our draft PR13 determination in June 2013;

(c) we agree that it is important to clarify how REBS interacts with alliances and we provide further information on this issue below;

(d) we acknowledge that the majority of train operators (passenger and freight) have concerns about downside exposure. However, our analysis suggests that some downside risk sharpens incentives and more than outweighs the cost (if any) of risk transfer. The design of REBS (i.e. asymmetric with capped pay-outs) limits the financial risk of participating in the mechanism, whilst providing some downside exposure for train operators; and

(e) we agree with consultees that REBS should not create an unnecessary regulatory and administrative burden on train operators. We address this issue in our decisions below.

Our decisions on REBS

3.13 In developing our decisions, we have considered the mechanism which best delivers our objective of aligning Network Rail's incentives with those of train operators (passenger and freight) to reduce its costs. We have also considered whether it delivers our objectives in line with the principles that we set out for REBS in our December 2011 consultation. According to these principles, we consider that REBS should:

(a) be as simple as practically possible in terms of understanding and implementation;

(b) have a high degree of industry buy-in;

(c) have support from DfT and Transport Scotland to relax Schedule 9 for new franchises, where required; and

(d) not restrict future opportunities for alliances.

3.14 We recognise that REBS provides private sector companies, i.e. train operators, with the opportunity to receive short-term financial benefits in return for helping Network Rail to deliver long-term industry cost reductions. We think that the capped pay-outs under REBS represent good value for money in terms of the wider efficiencies they will generate. Furthermore, although the focus of REBS is on outperformance and participating train operators will receive financial rewards for contributing to cost savings, they will also be at risk for a proportion of the costs resulting from any underperformance. It is not simply a 'no-lose' situation for train operators.

3.15 We set out below how each of our key decisions on REBS meets our objectives.

Upside and downside exposure

Our decision

That REBS includes upside (25% share of Network Rail's outperformance) and some downside exposure (10% share of Network Rail's underperformance), with caps (at 10% of out(under)performance) that limit financial risk for train operators and Network Rail.

3.16 Under the existing EBSM in CP4, train operators benefit financially if they can show that they have supported Network Rail in outperforming our determined efficiency assumptions. They receive a share (in proportion to their variable usage charge payments) of 25% of Network Rail outperformance in each year of the control period. Train operators do not, however, share in the cost of Network Rail's underperformance, i.e. it is an upside-only mechanism.

3.17 A mechanism providing both upside and downside exposure achieves our objective – of incentivising Network Rail and train operators to work together to reduce Network Rail's costs – more effectively than an upside-only mechanism because the downside exposes train operators to the risk of Network Rail underperforming the efficiency challenge that we set it at the periodic review. Whilst the general purpose of REBS is to drive outperformance and the expectation is generally of cost reduction, we consider that incentives are significantly strengthened, across the potential cost spectrum, if there is also some downside exposure. We have also taken into consideration governments' support of downside exposure and that, for REBS to be effective, i.e. franchised train operators are not held harmless to the financial impact of REBS, DfT and Transport Scotland need to include the mechanism within franchise contracts.

3.18 As part of our December 2011 proposal, REBS would allow train operators to share 25% of Network Rail's outperformance on support, operating, maintenance and renewals expenditure (and some elements of income), against the efficiency challenge that we set Network Rail as part of PR13. This is consistent with our existing EBSM sharing rule, which has been accepted by the industry (both Network Rail and train operators) in CP4, and we have not found any new evidence which would lead us to reconsider this sharing rule.

3.19 REBS will also provide train operators with a 10% share of Network Rail's underperformance, i.e. they will share in some of the costs of Network Rail missing its annual efficiency challenge for CP5, to sharpen the incentive. We do not consider that a symmetric mechanism is appropriate given the focus of REBS on outperformance and train operators' ability to bear risk. Our analysis on the impact of downside was presented in our December

2011 consultation and indicated that the additional risk to train operators from downside exposure of 10% is relatively small (for example, prior to taking into account the benefits of efficiency gains, our analysis suggests it accounts for less than 10% of train operators' expected profit) and, given that the mechanism is asymmetric, the expected pay-out is positive.

3.20 To avoid the undue impact of potential windfall gains and losses for train operators, and also to limit the risk exposure they face in relation to REBS (to retain franchise value), we have decided to cap REBS pay-outs at 10% of out(under)performance (for train operators as a whole), i.e. pay-outs to and from train operators will not exceed 10% of Network Rail's out(under)performance. We think a 10% cap strikes the right balance between sharpening the incentive and limiting the risk. The financial implications of these caps are presented in annex A.

Interaction with alliance arrangements

Our decision
That REBS pay-outs include the performance of alliances so that all operators are incentivised to support the delivery of efficiencies by the alliance.

3.21 We think that alliances are a very important driver of Network Rail and train operators working together to improve efficiency, i.e. these arrangements have the same objective as REBS. Alliancing is likely to be a better driver of efficiency than any regulatory mechanism we can put in place because they will be reached commercially and are therefore likely to better reflect the realities of the relationship on the ground and will have the buy-in of both sides.

3.22 We have considered how our recommendations for REBS, in relation to alliances, will affect incentives to enter into alliances and/or on the effectiveness of the parties within the alliance to work together efficiently. But it is just as important to assess the effect that the interaction of REBS and alliances will have on secondary operators, i.e. those operators within REBS but outside of an alliance.

3.23 We consider that the option for REBS to include the efficiency gain (or loss) from alliances best achieves our objective of incentivising Network Rail and train operators to work together to improve efficiency as it provides incentives on Network Rail, the alliance partner, and secondary operators to support route-level cost savings, both inside and outside of alliance arrangements. This is because secondary train operators are impacted by the financial performance of alliances, via REBS.

3.24 Although the alternative option, of REBS excluding the efficiency gain (or loss) from alliances, maintains a focus on infrastructure cost savings, it potentially provides perverse incentives on Network Rail and the alliance partner to 'make' and 'book' outperformance on the alliance partner-side and underperformance to Network Rail in order to reduce REBS pay-outs to other operators (or in the case of underperformance to increase the pay-outs from other operators), hence impacting the efficient working of the alliance.

Membership of REBS

Our decision
That REBS is voluntary for train operators, i.e. train operators are allowed to opt-out of REBS (by route) at the beginning of the control period (or at the start of their franchise).

3.25 Our initial proposal for REBS assumed that both Network Rail and train operator membership of the mechanism was compulsory. Under a compulsory REBS mechanism, train operators' membership would have been mandated, via track access contracts, with an opt-out for those train operators falling below a de minimis threshold[35].

3.26 However, with our support, and that of franchising authorities, the industry is moving towards developing alliance arrangements between Network Rail and train operators to drive out further industry cost savings and deliver better value for money. An example of this is the creation of the 'deep' alliance[36] on the Wessex route[37]. In this context, we have reconsidered whether train operator membership of REBS should be compulsory.

3.27 Although we considered that a compulsory REBS mechanism could have helped meet our objective of strengthening the alignment between Network Rail and train operators to improve efficiency, by providing a high degree of coverage of train operators and hence a high proportion of operating route costs, we had concerns about this approach, given the further emergence of alliancing and our longer-term vision of a more 'commercial' industry. For example, notwithstanding the asymmetric design of REBS, some train operators still consider downside exposure to be too risky when taking into account: the uncertainty of outperformance; the size of their profit margins; and that they may have to engage across a number of routes.

3.28 We therefore consider that it is more appropriate to allow train operators to make their own decisions, based on commercial considerations on whether to enter into REBS in CP5. Given the scope we see for better working together between Network Rail and train

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[35] The de minimis would allow an opt-out from REBS (for that route only) for train operators with low levels of traffic on an operating route.

[36] In Network Rail's draft statement on alliances, it defines a 'deep' alliance as one in which one of Network Rail's routes (or potentially part of a route) and a train operator share upside or downside risk against an agreed baseline for all or most of their activities. Network Rail's statement is available at: http://www.networkrail.co.uk/WorkArea/DownloadAsset.aspx?id=30064780829.

[37] Our statement on alliancing, published in March 2012 is available at: http://www.rail-reg.gov.uk/server/show/ConWebDoc.10854.

operators to generate efficiencies, we would expect train operators to have a strong incentive to enter into REBS, unless they were seeking to capture a proportion of these benefits through an alliance.

3.29 Recognising that, as the monopoly provider of infrastructure services, Network Rail could in principle decline to enter into any sort of efficiency benefit sharing arrangements (an alliance or REBS) with a train operator, we will oblige Network Rail to offer train operators the opportunity to participate in REBS. Train operators have the option to accept or reject this offer.

3.30 We intend to allow train operators to opt-out from REBS at the beginning of, but (except in the case of new franchises[38]) not during, a control period. This is to ensure train operators: can review our assumptions; are aware that Network Rail thinks the efficiency challenge is achievable; and are then able to decide whether they can make a difference[39]. The exception to this rule is in the event of an alliance[40] being agreed on a route within the control period. In this case, we will also allow secondary operators that are participating in REBS on that route to opt-out, where there is a direct financial impact on them which affects their position on REBS[41]. This is because in the event that another train operator on that route enters into an alliance with Network Rail, this will change the initial risk profile, potentially significantly (depending on the scope of the alliance) [42].

3.31 We consider this approach to be appropriate because the continuity of the incentive is important for its effectiveness as some of the actions that train operators will need to take, working with Network Rail, to generate efficiencies will need to be planned and implemented over a number of years. Additionally, because REBS is based on cumulative efficiency, train operators should not be able to benefit from early years of positive pay-outs and then opt-out mid control period in the event of underperformance.

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[38] We think that new franchisees should also be allowed to opt-out of REBS, reflecting the fact that they will have factored participation, or otherwise, into their franchise bid and should not be bound into the decision of the previous franchisee.

[39] We will consult on the necessary amendments to operators' access contracts to give effect to our proposals in our draft determination in June 2013.

[40] Train operators wishing to opt-out of REBS, following the creation of an alliance on their route, would have to satisfy us that the alliance would have a material impact on the risk to which they were exposed via REBS. We only expect this to be the case where there is a new 'deep' alliance on the route.

[41] We would expect Network Rail to inform any affected operators that an alliance had been agreed and for secondary operators to have a short period of time within which to decide whether or not to opt-out of REBS following the introduction of the alliance. As with the other proposed changes, we will consult on the necessary amendments to operators' access contracts to give effect to these proposals in our draft determination in June 2013.

[42] In particular, the issue that train operators engaged in REBS will now be directly impacted by the performance of the alliance, and hence the performance of another train operator.

3.32 Under this opt-out mechanism, train operators that enter into REBS will have had the opportunity to evaluate the risks involved in the mechanism before deciding whether to join and hence focus their efforts on reducing costs in areas where they have some influence. Network Rail will be required to offer REBS to all train operators (passenger and freight). By structuring REBS in this way, we target our intervention at Network Rail, which, by virtue of its monopoly position, has the ability and incentive not to enter into efficiency benefit sharing, while leaving train operators (who have the ability and incentive to enter into such arrangements in any case, if their franchise agreements allow them to benefit) free to decide for themselves.

3.33 We consider that the opt-out addresses some of the limitations of a compulsory REBS mechanism by improving train operators' buy-in to the scheme and reducing their risk exposure, whilst removing some of the barriers which might have otherwise prevented train operators from entering into efficiency sharing arrangements with Network Rail. The downside of an opt-out is that we potentially reduce the membership of REBS if train operators feel that they cannot sufficiently influence Network Rail's costs (and so opt-out of REBS altogether). We do, however, consider that this risk is more than offset by the benefits of an opt-out as outlined above, in particular improved buy-in and the ability of train operators to manage risk.

Further work

3.34 There are some aspects of the REBS design that we cannot yet confirm because these decisions are closely related to our approach to CP5 efficiency reporting, which we are consulting on in our draft determination in June 2013. These are the:

(a) process for setting REBS baselines;

(b) methodology for calculating and reporting REBS performance in CP5; and

(c) specific items of income and expenditure that will be included in REBS.

3.35 We want our approach to the measurement of performance for REBS to be consistent with our general approach to efficiency reporting for Network Rail in CP5 and so we will be consulting on the issues above in our draft determination. We will then set out our decisions in our final determination in October 2013.

3.36 Although we will not conclude on the specific income and expenditure items covered by REBS until our final determination, we set out our current thinking below.

3.37 In our May 2012 consultation we explained that we were minded to continue with the approach we set out in our December 2011 incentives consultation[43]. The one exception to this was the inclusion of small scale enhancement projects. We explained that we were minded to exclude these projects from REBS as we think that they are more suitable for bespoke/alliancing arrangements.

3.38 Our current thinking is consistent with the position we set out in May 2012, however we also consider that there are benefits to including Network Rail's Schedule 4 and 8 costs in REBS because it will encourage train operators to work more closely with Network Rail to improve performance and the management of possessions. It will also reduce the potentially perverse incentives on train operators to reduce Network Rail's costs, whilst being insulated from the impact of worsening performance via Schedule 4 and 8.

3.39 We will continue our discussions with industry stakeholders on all of the outstanding issues that we have discussed above and will consult on these in our draft determination.

[43] The income and expenditure included in our December 2011 REBS proposal included: support, operating, maintenance and renewals expenditure, small scale enhancements projects, and elements of Network Rail's property income.

4. Exposing train operators to changes in Network Rail’s costs at a periodic review

Key messages
• We are asking the governments to provide all new franchises with exposure to ‘technical’ (or cost-reflective) changes in the variable usage charge. • This change will only impact new franchised train operators from CP6, i.e. as a result of changes that we may make to Network Rail’s track access charges at our next periodic review. • We have decided not to implement the regulatory mechanism that we proposed in our May 2012 consultation to expose train operators to changes in Network Rail’s costs at future periodic reviews. • Given the proportion of Network Rail’s costs that are recovered through the fixed charge, we think that exposing franchisees to changes in the fixed charge would generate further efficiency savings. We will be working with the governments to explore how we can increase franchised train operators exposure to the fixed charge and to changes in it.

Purpose

4.1 The purpose of this chapter is to explain our decisions on exposing train operators to changes in Network Rail’s costs at a periodic review, including:

(a) background to the issue;

(b) the proposals that we have previously consulted on:

(c) responses to our consultations;

(d) our decisions; and

(e) further work required.

Background

4.2 In most regulated industries, the customers of the regulated companies have an incentive to engage with a periodic review, challenging the regulated companies’ costs (including scope of work and unit costs) to secure lower regulated prices. They do this because they benefit from these lower prices. In rail, franchised train operators currently do not have this incentive because they are held neutral (with some exceptions) through their franchise contracts to changes in Network Rail’s access charges as a result of our periodic reviews.

4.3 To complement our proposals on REBS, we have consulted on options which intend to support the creation of a more commercial customer / supplier relationship (between train operators and Network Rail). These policy options have broadly the same objective as REBS (i.e. to strengthen incentive alignment). But instead of incentivising within-control period efficiencies, they encourage train operators to engage with us and Network Rail during the periodic review process to drive down industry costs.

Consultation proposals

May 2011 and December 2011

4.4 In our first PR13 consultation in May 2011, we discussed a set of different options (complementary to our proposals for REBS) that took the form of normalising the customer / supplier relationship by exposing customers (train operators) to suppliers' costs through the charges they pay[44] at future periodic reviews. In particular we discussed doing this:

(a) through changes to Schedule 9 of franchise agreements, exposing franchised operators to changes in the variable usage charge (which reflect track wear and tear costs);

(b) by exposing train operators to changes in (a proportion of) the fixed track access charge; and

(c) by exposing operators to changes in a proportion of Network Rail's support, operating, maintenance and renewal (SOM&R) costs.

4.5 In December 2011 we set out a preliminary proposal for a mechanism that would share Network Rail's SOM&R cost risk (and potentially risk relative to some Network Rail income items), route-by-route (as determined at a periodic review), with train operators for control period 6 (CP6) onwards, i.e. option (c) above. We also explained why we were not developing our proposals for the other policy options further as part of PR13.

May 2012

4.6 Building on our prior consultations, in May 2012 we consulted on a more detailed proposal for exposing train operators to changes in a proportion of Network Rail's SOM&R costs. We also asked consultees whether we should reconsider one of our original proposals to expose franchised train operators to changes in Network Rail's variable track access charges at future periodic reviews.

[44] It is important to note that for these options to be effective for franchise operators, they require the support of the relevant franchising authority, in particular through reform of Schedule 9.

Exposure to changes in SOM&R costs

4.7 We consulted on a regulatory mechanism that would expose train operators to changes in a proportion of Network Rail's SOM&R costs, relative to a baseline, at future periodic reviews. Under the proposal, if train operators (as part of our next periodic review) were to help us to set a more challenging efficiency target for Network Rail than an agreed baseline (e.g. Network Rail's outturn costs from the previous control period), the mechanism would provide train operators with a financial reward. Alternatively, if our efficiency challenge was lower than the baseline, train operators would share in a proportion of the increased costs[45]. The proposal focused on the options for measuring performance against an expenditure baseline, i.e. the basis against which train operators would share a proportion of the difference between this and our periodic review determination.

Exposing franchised operators to changes in the variable usage charge

4.8 DfT and Transport Scotland asked us to reconsider our initial proposal to expose franchised train operators to changes in Network Rail's variable usage charge. We considered that the objective of this alternative option was broadly similar to our initial proposal. As a result, we consulted on this alternative option (in the form of a supplementary consultation[46]) and extended the deadline for consultees' responses.

4.9 DfT and Transport Scotland consider that, under this alternative option, franchised train operators should only be exposed to changes in charges caused by analytical evidence on cost causation and efficiency ('technical' changes) and not to the impact of changes that relate to different approaches to regulatory policy ('regulatory policy' changes). Otherwise, they are concerned that this could result in a reduction in franchise value.

4.10 Although the decision on whether to expose franchised train operators to track access charges, through the relaxation of Schedule 9, is the responsibility of franchising authorities, DfT and Transport Scotland have sought assurance from us that in future we will clearly separate the financial impact of any regulatory policy changes to our charging regime from technical changes on cost causation. This will allow franchising authorities to expose franchised train operators to only technical changes and for DfT and Transport Scotland to take liability for the impact of any changes in regulatory policy. We discuss examples of potential regulatory policy and technical changes in Annex B.

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[45] We proposed that pay-outs due under this mechanism would be in the form of adjustments to train operators track access charges.

[46] Our supplementary consultation is available at: http://www.rail-reg.gov.uk/pr13/PDF/aligning-incentives-letter-010612.pdf

Consultation responses

4.11 We summarised consultees' responses to our first two consultations in Annex A of our May 2012 consultation[47]. As such, we have not provided a similar review of these responses in this document but we do summarise the responses to our May 2012 consultation below.

Consultation responses – May 2012

4.12 There was significant support from consultees for increasing train operators' interest in Network Rail's costs but limited support for our proposal to provide exposure via a regulatory mechanism. Instead, consultees generally preferred approaches which provided exposure through the charging regime and considered that this was relatively simple and transparent. There was, however, recognition that train operators' financial exposure is limited under this approach.

4.13 DfT considered there to be significant risks with introducing our proposed regulatory mechanism to address this issue, due to complexity and value for money, and it suggested that we could achieve the same goals without a new regulatory mechanism. Transport Scotland had similar concerns about the proposal suggesting that such a mechanism could introduce complexity and has the potential for train operator windfall gains. However, DfT considered that there was scope within new franchises to provide exposure to charges (both variable and in future some elements of the fixed charge). Transport Scotland was also supportive of this proposal and considered that this should encourage the industry to work better together and allow us to set more challenging efficiency targets.

4.14 Network Rail did not agree that there is a need for our proposed regulatory mechanism and instead believe that alliancing and transparency could achieve the same aims. It suggested that this proposal could create adversarial relationships between train operators and Network Rail rather than encouraging cooperation. It did, however, support the proposal to increase train operators' exposure to charges and suggested that there were stronger reasons to do this than just encouraging train operators to participate in the periodic review process. It also noted the relatively low level of exposure of the proposal.

4.15 ATOC and train operators (such as Virgin Trains and Abellio) did not support our proposal to develop a regulatory mechanism and suggested that this could drive out franchise value. Responses from passenger train operators were more positive about our alternative proposal, with Virgin Trains suggesting that it is more likely to expose train operators to costs they are able to influence and Abellio agreeing that exposure should be limited to technical changes in charges (rather than regulatory policy changes). ATOC did, however, highlight

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[47] Our May 2012 consultation is available at: http://www.rail-reg.gov.uk/pr13/consultations/orr021.php.

that franchise agreements provide limited flexibility and that further exposure may drive franchise value down without leading to equivalent whole-industry cost reductions. ATOC also believes that alliancing would deliver behavioural change and incentivise more efficient outcomes than our proposal.

4.16 Freight operators and The Rail Freight Group (RFG) questioned whether it was appropriate to expose freight operators to costs, via a regulatory mechanism, where there is no coverage under the charging regime and they also considered that freight operators were already sufficiently exposed to Network Rail costs. This group of consultees were more supportive of our alternative proposal. RFG stated that it would maintain a clear link with the existing charging structure and DB Schenker and Freightliner noted that this is similar to the exposure already faced by open access operators (passenger and freight).

Comments on consultation responses

4.17 We have considered these responses in reaching our decisions, which are set out below. Having regard to the key comments from consultees, we make the following points:

(a) we agree that some aspects of the proposed regulatory mechanism are complex - we address these issues below;

(b) we accept that exposing franchised train operators to technical changes in the variable usage charge will provide relatively limited financial exposure, however, we consider this to be a significant step towards more commercial relationships between Network Rail and franchised train operators. We intend to also explore opportunities for further exposure to charges; and

(c) we acknowledge that provisions in franchise contracts could limit the ability of franchised train operators to respond to significant changes in the charges that it pays for use of the rail network. We address this issue below.

Our decisions on exposing train operators to Network Rail's costs at a periodic review

Decisions
That we ask franchising authorities to provide new franchises with exposure to technical (or cost-reflective) changes in the variable usage charge. That we work with governments to explore how we can increase franchised train operators' exposure to the fixed charge and to changes in it. And that we do not implement a regulatory mechanism to address this issue.

4.18 Considering our preferred direction of travel towards a more normal set of commercial relationships and less complex regulation, we think that there is a strong advantage in changing franchise contracts to expose train operators to a more appropriate level of risk –

essentially removing a distortion in the current regime – over an additional regulatory mechanism that would be designed to compensate for that distortion.

4.19 The Brown review is exploring the scope for providing franchised train operators with greater exposure to changes in Network Rail's costs (i.e. wider than our initial proposal for the variable usage charge) and as part of that review, we are arguing for greater franchise exposure to Network Rail's costs, through the charging regime, because we consider this to be aligned with our vision for a more commercial industry.

4.20 In our view, providing new franchises with exposure to technical (or cost-reflective) changes in the variable usage charge represents a significant step in the right direction and we are asking governments to provide for this exposure in all new franchise contracts. We accept that exposure to the variable usage charge through franchise contracts will provide less financial exposure than the regulatory mechanism we proposed in May 2012 (as a result of exposure to the variable usage charge, franchised train operators (as a whole) could benefit from lower charges by between £2m and £20m per year[48]). But, considering our preferred direction of travel towards a more normal set of commercial relationships and less complex regulation, we think that this represents a significant step towards meeting our wider objectives.

4.21 A major advantage over developing a regulatory mechanism is that changing train operators' exposure to the variable usage charge is relatively simple to understand and should not add a further level of complexity into the industry. Additionally, DfT and Transport Scotland are supportive of the proposal. As with REBS, this support is important because our decisions will only be fully effective if DfT and Transport Scotland amend Schedule 9 in franchise agreements to allow train operators to be exposed to the financial effects of the incentives.

4.22 As open access operators (passenger and freight) are already exposed to the full effects of any changes in variable track access charges that we make at a periodic review, and existing franchised train operators are held harmless to changes in the variable usage charge, our decision will only impact franchises as they are re-let, i.e. existing franchises and open access operators will not be directly affected.

[48] We have calculated the approximate range in reduction of the variable usage charge in CP5 in 2011-12 prices (if set as per the rules for CP4), based on our advice to ministers efficiency ranges (16% - 30%). However, in the event that we lowered our projection of Network Rail's long-run steady state efficiency, train operators could instead see their variable usage charges rise. It should be noted that the actual benefit for train operators will be lower as only new franchises will be exposed to these changes.

Further work

4.23 At future access charges reviews/periodic reviews we will always, as a matter of good practice, engage thoroughly with stakeholders, set out all of our proposals and decisions clearly and fully, and be transparent in respect of our technical and economic analysis. However, as a result of our decision, we will need to be even more explicit about the impacts that our decisions have on the structure and level of access charges paid by train operators, in order to be able to clearly distinguish regulatory policy changes from technical changes. This will enable franchising authorities to provide exposure to only those changes in charges to which franchisees are on risk.

4.24 This does not in any way fetter our discretion for reviewing and developing access charging policy. Rather, we need to ensure that there is clarity in our decisions to support DfT and Transport Scotland franchise policy. This will also enhance the transparency of our decisions. In annex B, we set out more information on how we will differentiate between regulatory policy and technical changes in access charges.

4.25 Given the proportion of Network Rail's costs that are recovered through the fixed charge, we think that exposing franchisees to the fixed charge would generate further efficiency savings, by giving franchised train operators an interest in challenging these costs and working with Network Rail to reduce them. Exposure to the variable usage charge provides franchised train operators with a relatively low level of exposure to changes in Network Rail's costs at a periodic review and as such we are considering the benefits of extending this exposure to cover Network Rail's fixed costs, i.e. costs currently recovered by Network Rail via fixed track access charges and direct government grants. This is not a change that can be implemented in the short term as it is likely to require significant changes to the existing approach to risk in franchise agreements and to our charging framework (e.g. being clearer about the costs that are recovered through the fixed charge and network grant).

4.26 The decision on whether to increase franchised train operator exposure to changes in Network Rail's fixed costs is ultimately for the governments to make. As such, we will be working with DfT and Transport Scotland to explore the opportunities for increasing franchised train operator exposure to Network Rail's costs.

4.27 We recognise that providing exposure to changes in Network Rail's fixed costs is a significant departure from existing industry arrangements and would expect that any further exposure to Network Rail's costs is phased in over more than one control period (i.e. from CP6 onwards).

Annex A – Extent of financial exposure for train operators under REBS

Background

1. The potential risks and rewards faced by train operators is an important consideration in designing an appropriate mechanism to incentivise train operators and Network Rail to work together to improve cost efficiencies. Our proposal for REBS takes this into consideration with an asymmetric design which puts the emphasis on outperformance/upside and caps which limit operator exposure.
2. We have considered the financial implications of REBS in three main ways, with the key aim being to better understand the potential impacts on Network Rail, passenger and freight train operators so that we can establish the parameters to achieve the most appropriate balance of risk and reward.

High-level assessment

3. We considered the potential risks and rewards of REBS at an overall industry level.
4. We estimate that under our proposals, the maximum downside exposure for train operators (passenger and freight) is approximately £40m per annum.
5. For passenger train operators, the maximum downside is approximately 0.8% of Network Rails support, operating, maintenance and renewals (SOM&R) expenditure. Across Great Britain, this is about £32m per annum, which is less than 0.5% of passenger train operators' turnover and approximately 10% of passenger train operators' pre-tax profit (assuming a pre-tax profit of £300m per annum). We have calculated this as a 10% share of Network Rail underperformance capped at 10% on SOM&R expenditure of approximately £4bn per annum, allocated by passenger train operators' share of the variable usage charge (80% of £180m per annum).
6. We estimate that under our proposals, the maximum upside exposure for train operators (passenger and freight) is approximately £100m per annum.
7. For passenger train operators, the maximum upside is approximately £80m per annum across GB, based on a 25% share of outperformance, capped at 10%. This is:
   (a) 2% of Network Rail's SOM&R expenditure.
   (b) 1.1% of passenger train operator turnover; and

(c) 2.7% of passenger train operator pre-tax profit

8. Freight operators account for approximately 20% of total variable usage charge payments and so based on the information above, freight operators, would be exposed to a downside of up to £8m per annum and an upside of up to £20m per annum.

9. Note that all of the values above are sector totals, before any allocation to individual train operators, which in REBS is based on their relative share of variable usage charges[49].

Statistical modelling

10. In annex B of our December 2011 incentives consultation, we summarised the results of our illustrative statistical analysis which sought to estimate the impact of our REBS proposal on train operator and Network Rail finances. This analysis considered five stylised operators on indicative operating routes, e.g. an operator serving a single route or a large national operator, and simulated a large number of scenarios of out(under)performance across operating routes. For Network Rail, our analysis suggested that, taking account of variations between routes, REBS would marginally reduce Network Rail's downside risk. Depending on how the baseline is set, it may also increase Network Rail's expected profit through train operators' actions to reduce costs. Estimates of the infrastructure cost savings that could be achieved through REBS are difficult to determine. However, our indicative analysis suggests that REBS could help reduce costs by up to £250m over the control period as a result of train operator efforts.

11. Table A1 shows the impact on train operators' profits (on a control period basis) and also that REBS is likely to result in an increase in train operators' risk. For example, over the control period, a concentrated train operator stands to gain approximately £12m (7% of profit) on average from REBS and in the worst case could pay Network Rail up to £10m (6% of profit) in the event of Network Rail underperformance.

Table A1: impact on operator profit from REBS (£m)

Stylised operator	Mean	Standard deviation	"Worst case" (1 in 20 CPs)
Highly concentrated	£24 (14%)	£21	-£10 (6%)
Concentrated	£12 (7%)	£14	-£10 (6%)
Concentrated, small	£1 (3%)	£2	-£2 (5%)
National, large	£8 (5%)	£9	-£7 (4%)
National, small	£2 (4%)	£1.8	-£1 (4%)

Source: Annex B, PR13 December 2011 incentives consultation

[49] If the income and expenditure included in REBS differ from our assumptions, the value of the cap (in £ millions) will change.

12. The additional risk from REBS is relatively small (for example, prior to taking into account the benefits of efficiency gains, our analysis suggests it accounts for less than 10% of train operators' expected profit) and, given that the mechanism is asymmetric, the expected pay-out is positive. If the additional risk from REBS is small relative to the portfolio of risks that the train operators already bear, as it has low correlation with those risks, then the potential cost of train operators' downside risk (from REBS) may be negligible.

KPMG's modelling

13. Jointly with ATOC, we commissioned KPMG to assess the impacts of our proposed REBS design on the profitability of train operators, and in turn the potential impact on franchise bids. This work involved modelling of the financial impacts of REBS for operators on three different operating routes, across three control periods, and holding discussions with owning groups to understand their views on the likely impact of the mechanism. KPMG's analysis suggested that, based on the modelling assumptions, REBS would be likely to have a small positive impact on train operator profits of up to 2%, although this could vary by route depending on the size of the operating route cost base, relative to train operator costs and turnover. Discussions with owning groups highlighted some concerns with REBS. These focused on the accuracy of Network Rail's efficiency reporting and hence on our confidence in the level of efficiency actually achieved; the weakening of incentives towards the end of the control period; and the possible negative impact on bid margins. These uncertainties led owning groups to suggest that REBS would not result in an increase in bid margins. There was strong support for caps on downside exposure, without which owner groups suggested that they would price the risk of REBS into their bids negatively.

Annex B – Regulatory policy and technical changes in the access charges

Overview

1. We are asking franchising authorities to provide all new franchises with exposure to 'technical' changes in the variable usage charge as we think this will improve the alignment of incentives between Network Rail and train operators and is a significant step towards more commercial relationships within the industry. We do not consider that this restriction (i.e. to not expose franchised train operators to regulatory policy changes) will materially weaken incentives because current franchising arrangements give franchisees very limited flexibility to change how they provide services. If we were to make a regulatory policy change, it is likely that we would do so to send train operators (passenger and freight) better signals to influence their behaviour. However, if franchisees are not able to change their behaviour (due to the inflexibility in their franchise contracts) in response to a regulatory policy change, then we lose nothing by holding them neutral to these changes.
2. In Chapter 4, we explained that we would like to see more flexibility in franchise contracts so that franchisees are better able to respond to market signals (which reflect what their customers want and need). Although a decision on increasing the flexibility of franchise contracts is for franchising authorities to make, if this does happen, we would want to re-visit whether these more flexible franchises should still hold franchisees neutral to regulatory policy changes in charges.

Defining regulatory policy changes and technical changes

3. To support franchising authorities in exposing new franchised train operators to changes in track access charges at future periodic reviews, we set out in our May 2012 consultation an explanation of how we expected to differentiate between 'technical' (or cost-reflective) changes and 'regulatory policy' changes in track access charges. We expand on this explanation below.
4. We will undertake further work with the franchising authorities to develop these definitions.

Regulatory policy changes

5. If we were to change the theoretical basis or regulatory policy underlying a charge/compensation mechanism, then we recognise that it may not appropriate to put

franchised train operators on risk for this where they are not able to influence the impact on their businesses. For example, under the existing franchise arrangements the ability of franchisees to change their behaviour by changing the number, nature or stopping patterns of their services in response to a policy change that would increase variable usage charges would be limited by the provisions in their franchise agreement.

6. The variable usage charge is designed to recover Network Rail's maintenance and renewals costs that vary with traffic; in economic terms this reflects the short run marginal cost. This means that the charge does not reflect the actual costs of providing or changing the capability or capacity of the network[50].

7. Examples of regulatory policy changes[51] to the variable usage charge could include changes relating to:

    (a) the balance of recovery of Network Rail's costs from fixed charges to variable charges (e.g. by moving to a long-run marginal cost approach): if we were to change the basis of the variable usage charge so that it also reflected long run marginal costs, i.e. reflecting more of the costs of changing capability and capacity of the network, then we consider that this would be a change in regulatory policy as we would have made a change to the theoretical basis of the charge;

    (b) capacity-related mark-up: if we were to include in the calculation of the variable usage charge an element that reflected the cost incurred by Network Rail from providing additional capacity on the network (this could be cost-based or value-based), we would consider this to be a regulatory policy change;

    (c) long-run efficient steady state approach: in PR08 we set Network Rail's variable usage charge to recover variable usage costs based on the long run efficient steady state cost. A long run efficient steady state cost is one that excludes catch-up inefficiency or backlog expenditure. Network Rail is not yet operating at its long-run efficient steady state and so its costs are currently higher than our forecast of its long-run efficient steady state level. If we were to change the basis of the charge so that it recovered Network Rail's actual wear and tear costs, e.g. end of prior control period costs, then we would consider this to be a regulatory policy change; and

    (d) costs directly incurred: the variable usage charge is intended to recover the cost directly incurred by running trains on the network. If we were to change the costs that we considered are 'directly incurred', e.g. to widen or narrow its scope, this could

[50] These costs are captured by the fixed charge or specific charges for enhancements.

have an impact on the level of the variable usage charge and we would consider this to be a change in regulatory policy.

8. In some cases, however, the financial impact for train operators, as a result of regulatory policy changes to charges can be negligible. In these cases we would expect the franchising authorities and franchised train operators to work together to decide whether it was cost effective to retain protection in this area. For example, it is possible that the costs of implementing minor updates to franchise premium/subsidy payments may outweigh the cost/benefit to the train operator of these changes.

9. We fully recognise that any such regulatory policy changes would need to be conducted in line with the legislative framework, including the Access and Management Regulations.

Technical changes

10. If we were to solely make changes to the levels of the charge, built-up from changes to individual parameters, i.e. technical changes, without changing the theoretical basis for the definition of the charge or the parameter, then we would set this out clearly. It would be our expectation that franchised train operators would bear the financial impact (positive and negative) from any such changes because we would be making such changes to: improve cost reflectivity; send better signals for behaviour; and because we believe franchisees could respond to these changes.

11. Examples of technical changes to the variable usage charge could include:

    (a) additional terms that are included in wear and tear calculation: in PR08, we introduced a new term into the variable usage charge model for allocating the charge between freight and passenger traffic and between individual vehicle types. This term reflected the impact of lateral and longitudinal forces when allocating the charge between vehicle types. As this change was the result of additional information on track damage we consider this to be a technical change;

    (b) route-based efficiency evidence on Network Rail costs and changes to model parameters: any changes to the variable usage charge that results from new route-level evidence on costs would be classed as a technical change. This is simply additional information that allows us to make the charge more costs reflective; and

    (c) disaggregation of the variable usage charge: the current variable usage charge is calculated as a network average, i.e. there is a single GB-wide ‘price list’ for each vehicle type. That is, it takes no account of differences in variable costs, on different route types or between areas with different funders, i.e. England & Wales and Scotland. If we were to implement a charge that varied by geography so that the charge was more cost-reflective, we consider that this would be a technical change as geographically disaggregating the variable usage charge does not change the underlying purpose of the charge or the costs it is seeking to recover.

12. Giving effect to this decision, any ‘material’ regulatory policy changes would lead to the creation of a new charge, e.g. variable usage charge A or B, whereas technical changes would be incorporated into the existing charge. For the purposes of Network Rail billing or public presentation, the separate charges that make up the variable usage charge, e.g. ‘A’ and ‘B,’ could be combined.