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14 October 2011

Dear Gian Carlo

PERIODIC REVIEW 2013: ESTABLISHING NETWORK RAIL'S EFFICIENT EXPENDITURE

Thank you for the opportunity to comment on your proposals to establish Network Rail's efficient expenditure. Delivering a robust assessment of Network Rail's expenditure is one of ORR's key roles; it is crucial ORR gets this right, determining as it does Network Rail's allowed revenues for CP5.

The consultation document is a useful first step in establishing the overall approach but we would make the following comments:

- It is important there is a clear understanding – before the process begins in earnest – of the overarching objectives the assessment process is seeking to achieve, what the means of delivering these will be and how the work fits within the wider context of PR13 and industry reform. In light of industry reform we believe these objectives should focus on defining robust estimates of efficient expenditure for the devolved Network Rail routes and, where appropriate, those functions that will be retained centrally. In this context it is difficult to get a clear sense how it is envisaged the various detailed benchmarking analyses proposed will be drawn together into a coherent set of conclusions. For example there are approximately 34 studies looking at various aspects of OM&R spend at international, national and sub-national levels; all of these will need a strong degree of coordination if they are to provide consistent, meaningful results to feed into route level settlements.
- As reflected in the conclusions of the McNulty VfM Study, the industry needs to have confidence that the ORR as an organisation has the appropriate skills and resources to carry out this process effectively. This does not simply mean having the ability to perform detailed benchmarking analyses; these skills need to be allied to good engineering and asset management expertise in order to understand the key cost drivers and provide a robust challenge, where necessary, to Network Rail's proposals. This is a particularly important issue in terms of assessing M&R expenditure where there is no substitute for a detailed knowledge of the engineering side of the business.
- While we acknowledge the progress that has been made in refining the benchmarking analysis for PR13, we believe there needs to be:

- A recognition that benchmarking is a means to an end rather than an end in itself. There must always be a clear view as to why a particular benchmarking technique is being applied and the insight is intended to provide;
 - An understanding of the relative strengths and weaknesses of 'top down' vs. 'bottom up' approaches – including the context within which each is best applied – and how the two can be brought together to form a coherent view on the efficiencies Network Rail should be able to achieve;
 - An acknowledgement that, while more sophisticated models may be able to provide improved insights, they remain reliant on the quality and amount of input data. ORR will need to ensure that Network Rail provides sufficiently robust data at a disaggregated level for the modelling to be useful.
- Further, there must be a clearly defined path from the outputs of each benchmarking exercise to a set of firm conclusions. There may, for example, be large differences in unit costs both across NR routes and between the routes and other comparators. The reasons for these differences will to be further understood, in particular whether they are a result of e.g. variations in network characteristics or outputs or whether there is a genuine efficiency differential. As already noted, this sort of analysis requires a deeper understanding of asset management and engineering activities and what drives cost in these areas.
 - In terms of support and operations costs we have some concerns over precisely how these are constituted and how ORR intends to ensure that this expenditure can be allocated accurately at route level (and/or centrally if all or parts of these functions are not devolved). Looking at Table 4.1 it is not immediately clear whether the expenditure shown against each function reflects the direct cost of provision or includes some element of the value each function generates and/or some other overheads. For example strategic sourcing is a relatively small central team within Network Rail but which handles high value procurement contracts. In this context the associated expenditure of £47m appears high if this figure reflects just the direct costs of provision. Similar arguments equally apply to other items e.g. human resources. We would therefore encourage ORR to assess in detail the precise scope and allocation of these expenditure items at route level and the breakdown of each as part of this process.
 - Further, we believe there are a number of 'non-controllable' costs that are in fact controllable by Network Rail to some degree. EC4T costs are a clear example of this. While EC4T costs are primarily driven by train operators' consumption, a large proportion reflects system losses which are simply passed through to train operators. These losses can, to a degree, be controlled by Network Rail through the infrastructure investment/operation decisions they make. This is particularly the case on the 3rd rail DC network where recent studies suggest system losses could be high, in the region of 27%. Allowing for a range, this equates to a cost of some £20-30m per annum for DC operators. As noted in our response to the first PR13 consultation document, we believe Network Rail should be incentivised to reduce system losses where it is reasonable for it to do so, possibly by setting an efficient level of losses for which it can recover costs. Similarly it is arguable that Network Rail has a relatively strong degree of control over BTP costs as it is represented on the BTPA, a role that includes negotiating the Police Services Agreement (PSA) and setting the budget for BTP.

- With regard to enhancements expenditure we are concerned that, although Network Rail was provided with the CP5 Development Fund in PR08, there remains a lack of clarity over the sorts of schemes that will be firmed up for CP5. While we have a broad understanding of the sorts of schemes under consideration there is very limited visibility of how much of the fund has been spent and the detail of individual schemes. In light of this we would encourage ORR to review as a matter of urgency the precise status of schemes being developed using the fund.
- It is apparent that Network Rail's intention to reduce its key OPEX element is a long term plan based on the Network Operating Strategy (NOS) to be completed in around 2035, or CP8. In order for the NOS to achieve the efficiencies claimed, it needs to be planned and delivered with a certainty which is not readily available with the present structure of price reviews every five years. If Network Rail is unable to develop reliably its signalling renewal programme which delivers the NOS over a time horizon greater than five years, then operators will be at an even greater disadvantage than at present to influence such renewal schemes so as to incorporate simple but highly desirable infrastructure enhancements in a cost effective manner.

I hope these comments are helpful. Please do not hesitate to contact me if you would like to discuss in more detail.

Yours sincerely

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Director, Policy & Operations