ORR PR13 consultation event
Manchester
The Studio, 51 Lever Street, M1 1FN

21 July 2011

Slides of all presentations are available on the ORR PR13 website (http://www.rail-reg.gov.uk/pr13/). As there is no slide set from Charles Robarts' presentation a summary of his comments is set out in Annex A.

MORNING SESSION – PR13 in context of industry reform

1. The session commenced with comments from:

   a. Paul McMahon, Deputy Director, Railway Markets and Economics, ORR, setting out the goals and objectives for the day and an overview of PR13;

   b. Michael Beswick, Director or Planning and regulation, ORR, who spoke about PR13 within the broader context of industry reform; and

   c. Charles Robarts, Director of Rail Strategy, Network Rail, who spoke about PR13 from Network Rail's perspective.

2. The purpose of this event was to discuss PR13 in the broader railway context and the PR13 consultation document published on 25 May 2011. ORR's intention was to have an open discussion on the issues and inform stakeholders' views for the formal responses to the consultation which closes on 2 September 2011.

3. Presentations were followed by a general panel discussion with the audience.

4. Q 1: The details of the renewal and enhancement programme for CP4 was settled right at the last minute on 31 March 2009. It would be helpful, particular for suppliers, if this area could be settled a few months earlier to enable the rail industry to be able to 'hit the ground running' at the start of CP5.

Panel response

5. The panel acknowledged that in the past there has been a hiatus between control periods caused by the late decisions on the works that Network Rail would be undertaking. The panel agreed that this situation needed to be improved.

6. It was noted that this time around, there would be a hangover of major projects between CP4 and CP5 because of schemes like Thameslink. Also, Network Rail's asset policies should be more robust. This should reduce the likelihood of major changes in work levels between control periods and corresponding uncertainty for suppliers. Nonetheless, this issue would be looked at.

7. It was also acknowledged that Network Rail needed to plan and manage renewals better. This time around, Network Rail would have a better idea of what projects would likely proceed and these would be further developed in the 'GRIP' process compared to the last periodic review. It would also be important to use the concept of an 'early start' in terms of getting assurance earlier about what will be going ahead. ORR would also look at whether certain key dates in the process could be brought forward.

8. Q2: The hiatus that occurs between control periods leads to a significant waste of time for engineering companies. This raises issues about efficiency. Secondly, the industry in general needs to react more quickly to using new technology, particularly now that franchisees are to be given more freedom. ORR should perhaps consider how the industry responds to change, as this currently is not handled well.

Panel response

9. The panel recognised that industry needs to respond to change better. A hiatus in work does not encourage efficiency or innovation. The panel acknowledged the importance of taking action in this area and this would be taken forward.

10. Q3: With devolution to route level within Network Rail, is the panel satisfied that this will be done without compromising safety?

Panel response

11. The panel agreed that it was vital that devolution to route level needed to be managed properly with the necessary governance/safety arrangements put in place. Devolved routes would not go live until safety assurance had been achieved.

12. Q4: In the context of industry reform, the importance of the price mechanism cannot be ignored, particularly when one looks at how it has or has not influenced behaviour in the past. Most franchised passenger track access charges are fixed charges. Accordingly, there are few incentives on operators to do things differently and respond to the price mechanism.

13. For example, there is an issue about access to the network for engineering work. When installing electrification equipment, only one electrification train is used even though it would be significantly more efficient to use two. Access to the network for engineering is probably too cheap a resource at present and thus provides an insufficient incentive to drive efficient behaviour. As an industry, we have been too cowardly to use the price mechanism to effect change.

Panel response

14. ORR has always believed in the benefits of the price mechanism. However, for franchises, most of the price incentives currently in place were switched off because of provisions in franchise agreements. ORR was hopeful that, with industry reform, franchise authorities would relax these provisions. This would give train operators more flexibility. The 'Efficiency Benefit Share' was one such mechanism currently in place that applies for freight and open access operators but which was switched off for franchised operators.

15. Currently, the vast majority of revenue from track access charges was raised through fixed charges. In PR13, ORR would be looking at whether this should change. However, it needs to be borne in mind that a high proportion of Network Rail's costs are fixed, which to some extent restricts how much scope there is to change the proportion of the fixed charge.

16. ORR was also considering whether new types of charges, including scarcity and reservation charges, should be introduced to improve incentives. ORR was very interested in views in this area and looked forward to receiving these in stakeholders' consultation responses.

17. It was acknowledged that PR13 needed to consider whether the schedule 4 (possessions regime) worked effectively and delivered appropriate price signals. Network Rail also acknowledged that the managing of engineering access could be improved, and that there was perhaps a disconnect at present with those on the ground not understanding the key drivers.

18. The panel also acknowledged a concern that was raised in that PR13 might only deliver a minor variation of the existing schedule 4 regime. It mentioned that there was a real opportunity over the next twelve months for the industry to consider how this area could be managed differently and develop a coherent story for how this might be done. Devolution would help, in terms of Network Rail working more closely with its customers. Franchise reform which stops train operators being held neutral to changes to schedule 4 at periodic reviews would also be important.

19. Q5: Given current austerity, it would be surprising if the funding side of PR13 is not constrained, with the Statement of Funds Available (SoFA) being insufficient to fund the High Level Output Specification (HLOS). If so, efficiency will be of critical importance in CP5. In this case, what levers will ORR introduce to support the delivery of this greater efficiency to enable maximisation of value?

Panel response

20. It was noted that ORR had a statutory role in deciding whether the SoFA contained sufficient funds to deliver the HLOS. As part of this, it was important to bear in mind that this process did not just consider costs of delivery but also revenue growth, which would be a key factor.

21. Ultimately it would be for industry to deliver the cost savings required. The initial industry plan (IIP) which the industry would be producing by the end of this

September would set out how it thinks greater efficiency can be delivered as well as the projects that it wishes to see implemented. This will include how government can do its part to support increased efficiency. ORR will take a view on what can be achieved in terms of efficiency savings as part of PR13. The advantage of the existing regulatory asset base (RAB) approach was that there would be opportunities to ‘spend to save’ and benefit from whole-life cost savings.

22. It was also mentioned that ORR would be publishing a document next week on establishing Network Rail’s efficient expenditure and that there would be a separate workshop in due course to discuss this.

23. In addition, the efficiency benefit sharing mechanism would help efficiencies be delivered more quickly by encouraging cooperation between train operators and Network Rail in this area.

24. Q6: Recognising the importance of revenue growth, it is important to consider the relative value of new income to existing revenue and the relationship between retaining the existing customer base and seeking new customers.

Panel response

25. The panel acknowledged this and, whilst it was important not to lose sight of improving the bottom line to reduce costs, emphasised again the importance of revenue growth. ORR in particular looked forward to discussing what could be done to encourage Network Rail to be more aligned with end-customers.

26. Q7: The railway has a great future. It is really important that we consider how to make the best use of existing capacity and recognise the importance of railways in society today and the benefits that improvements can bring, particularly at a local level. Also, as an outsider to the rail industry, there does seem to be a lot of jargon used to discuss these issues.

Panel response

27. The panel agreed that the industry had a promising future. However, it would be important to ensure that it can achieve better value for money in order to make its contribution on a sustainable basis. The panel considered that localisation of decision making would support the delivery of improvements at a more local level to bring valuable societal benefits.

28. The use of jargon was acknowledged. It was hoped that events like this, in involving a wide cross-section of stakeholders, would help to cut through some of the more opaque language typically used in the industry and periodic reviews in particular.

29. Q8: The Passenger Performance Measure (PPM) is very important to the industry. The PR13 consultation document makes the connection between PPM and passenger usage. Is PR13 going to give Network Rail the opportunity to raise PPM on routes where usage has significantly increased?

Panel response

30. The panel noted that it was unlikely that the HLOSs/ PR13 would seek to increase PPM targets beyond what they were at present although that was an issue for government too. Rather, the focus would more likely be on those train operators/routes where PPM has been variable to bring PPM up, on a consistent basis, to the levels seen on the best routes.

31. Q9: It is important to invest to reduce operating expenditure. Can the panel expand on the benefits of introducing risk capital through unsupported debt?

Panel response

32. It was noted that Network Rail, as a company limited by guarantee without shareholders and as a company whose debt was guaranteed by government, did not face the same corporate incentives as other limited companies. In terms of the government debt guarantee, this meant that lenders were not so concerned about what Network Rail does with the money it borrows because, whatever happened, they have certainty that they will get their money back. If Network Rail were to borrow without the government guarantee, lenders would treat it like a conventional company and scrutinise more closely what Network Rail did with the money it borrowed. This would boost the incentive on Network Rail to deliver efficiently, as there would be financial consequences if it failed to do so.

33. The panel noted that the 2008 periodic review provided for Network Rail to take on unsupported debt. However, the meltdown in the financial markets at the time meant that it was not feasible for Network Rail to do so.

34. Q10: Passenger transport executives (PTEs) are accountable to their Integrated Transport Authority. With devolution and proposed localisation of responsibilities to PTEs, how will ORR regulate localisation so that it works effectively?

Panel response

35. It would be for local authorities to make localisation work and they would need to demonstrate to government that they are able (including financially) to take on these responsibilities. ORR could help facilitate localisation through greater transparency of costs. Also, through the periodic review process, ORR would support localisation through balancing the interests of all relevant parties – such as funders (including those at a local level), train operators and Network Rail.

36. Q11: PTEs have an incentive to encourage the use of public transport. Currently, my PTE is trying to encourage more people to switch to rail than Network Rail is planning for in terms of accommodating growth. How do you reconcile this?

Panel response

37. We need to get to a situation where Network Rail supports PTEs' objectives. However, if ultimately a PTE wants Network Rail to provide capacity beyond the

funding available, there is clearly going to be a problem. However, localisation will provide for local funding which will be important in supporting delivery of a PTE's objectives.

38. Q12: Devolution of Network Rail is a significant issue for freight operators who operate services that need to pass through many routes. Currently there is an issue about passenger train operators with poor train utilisation. For freight operators, addressing this is important because there are often under-utilised passenger trains operating which prevent freight operators from getting the paths that they would need to run extra services.

Panel response

39. The panel recognised that freight operators competed in a very competitive market and so focused strongly on maximising train utilisation to help drive down costs. The problems with train utilisation identified by the rail value for money study (McNulty) went beyond the issue of relatively empty trains and included the need to make best use of capacity by operating longer trains where demand existed and to consider off-peak and peak services in this context. A study was in progress on how to improve train utilisation.

AFTERNOON SESSION – Discussion about outputs, incentives, structure of charges and financial issues.

40. Paul McMahon set out the procedure and expectations for the afternoon session. Paul also explained the importance of delegates providing written feedback on the consultation document: discussions in the technical sessions were not a substitute for providing written responses.

How to structure the outputs Network Rail should deliver – presentation and discussion led by John Larkinson, Deputy Director, Railway Planning and Performance, ORR

Discussion

41. A participant highlighted potential issues with specifying outputs at a high level. For example, an output which specifies 'x' amount of track renewals could incentivise Network Rail to renew track where the costs of doing so are lowest and not where renewal is most needed. The participant did, however, identify the PR08 strategic freight network fund as a successful example of where an output was specified at a very high level but through cross-industry working, a positive outcome was achieved and savings were made. ORR noted that a key incentive in the schemes like this is for savings to be retained by those who contribute to the success i.e. allow those who make the savings to benefit from this.

42. This led to a discussion on the success of other 'funds' such as the 'performance fund' and 'seven-day railway fund'. Participants felt that these other funds had not been as successful. ORR pointed out the different purposes of these funds: the strategic freight network fund had a general outcome (freight improvement), whereas Network Rail was free to determine how, and if, the 'performance fund' and 'seven-day railway fund' should be used because these were

linked to its regulatory targets on performance and reducing disruption from possessions. Participants generally felt that the purposes of the other funds were not clear and that criteria for building business cases to receive money from the funds needed to be clarified.

43. One participant thought that outputs should be differentiated (or disaggregated) by geography and explained that national measures are irrelevant to local rail users as these don't reflect the varied experiences across the network. Another participant suggested that outputs should be at the operator level, with the caveat that this depended on the make-up of areas in terms of numbers of service groups. It was thought that operator-level measures would allow operators to prioritise work more effectively and make best use of available resources.

44. A delegate did however raise a concern about disaggregation and warned that commonality of the structures and frameworks could be lost which would make output comparisons across the network difficult. ORR stressed the need to find a balance between the level of disaggregation and the risk of reducing Network Rail's flexibility to find the best ways to manage resources.

45. Using customer satisfaction as a measured output was suggested by one delegate and ORR was asked for its view on this. ORR explained that customer satisfaction levels were already built into at least one franchise agreement but highlighted some issues with using these measures, such as how to manage changing expectations when forecasting. ORR also noted that it is up to governments to determine, in the HLOS, whether customer satisfaction measures should be a specified output.

46. The final point in this session covered the potential for objectives, set out in franchise agreements and the HLOS, to conflict and that there needs to be close alignment when developing the HLOS (and new franchise agreements) to stop this from happening.

Financial issues, including disaggregated price control – presentation and discussion led by Carl Hetherington, Head of Regulatory Finance, ORR

Discussion

47. A participant asked how greater controls would be imposed on Network Rail if it were to issue unsupported debt. ORR explained that issuing unsupported debt would actually bring greater discipline, not control. Due to greater scrutiny from financial institutions, Network Rail would be required to improve the financial information provided to the market. ORR also highlighted an additional benefit of transferring risk from the taxpayer, towards private investors.

48. Another participant asked what level of disaggregated data would be required from freight operators. ORR noted that at the current time, freight operators were not being asked to provide further financial data as priority was being given to passenger data. ORR would, however, review this position in the near future.

49. On the issue of control period length, longer control periods were favoured by freight operators as this was anticipated to increase confidence in the sector, due to

greater stability. The effect of this would be increased investment in infrastructure and rolling stock.

50. One participant asked how flexible the financial framework was, bearing in mind the potentially industry reform as a result of the rail value for money study (McNulty), in particular, whether it can cope with changes to HLOS process and how this interacts with franchise agreements and the periodic review. ORR explained that the framework was robust and flexible enough to cope with industry change. For example, re-openers are included which allow the determination to be re-considered in certain circumstances. ORR will be meeting with the DfT in the coming weeks regarding the interaction between the HLOS and periodic review.

51. One suggestion from a participant was to link particular projects, with well defined cost-benefit ratios, to the issuance of unsupported debt. ORR noted the possible benefits but also that it may be difficult to find ‘standalone’ projects which are so clear cut (as to the costs and benefits). ORR also noted that unsupported debt may add complexity and cost to projects and there may be other ways of achieving efficient delivery – they would not enforce the use of unsupported debt if this does not bring benefits.

52. The creation of a rail industry inflation figure was suggested. ORR said that it would consider this proposition but cautioned that Network Rail would dominate any potential index.

53. The high cost of particular rail projects was raised as an issue, with the example of enhancements undertaken at Birmingham New Street station. ORR explained that major enhancement projects are included in Network Rail’s accounts and so information of this type of expenditure is available. ORR also highlighted that views on cost-effectiveness of projects were often subjective and that in relation to the periodic review, ORR would look to determine revenues and incentives which encouraged work to be carried out efficiently.

Setting incentives, including joint incentives on Network Rail and train operators – presentation and discussion led by Paul McMahon, Deputy Director, Railway Markets and Economics, ORR

Discussion

54. On the topic of revenue sharing, one participant highlighted that schedules 4 and 8 were already trying to achieve the same objectives (collaboration and joint-working) and asked whether ORR had reviewed the actual decisions being driven by the incentive mechanisms already in place. The participant also suggested that current incentives may not have the same impact across train operators and Network Rail. For example, train operators factor in possession costs when carrying out work but questioned whether Network Rail did this too. ORR noted that it will be looking at incentives in detail soon, including the decisions that result from the current mechanisms.

55. A participant suggested that it would be simpler to have charges reflecting best outcomes e.g. simplifying charges even if they do not fully reflect the true cost of a possession. One participant suggested that often the most senior levels of

management in organisations don't fully understand schedule 4 and that it is unlikely to be driving strategic decisions. Another participant felt that the principle of schedule 4 was straightforward but it was the actual conversion into monetary terms where the difficulties lie.

56. ORR noted that it had looked to simplify these mechanisms in the past but after incorporating various industry views, this resulted in a very similar mechanism to the existing situation.

57. The final point in the session raised the validity of using starting and termination points to determine delays. One participant felt that in many cases these points in the journey may actually be the least important for customers. For example, the end point may have very few people alighting.

The structure of charges that train operators pay – presentation and discussion led by Paul McMahon, Deputy Director, Railway Markets and Economics, ORR

Discussion

58. Concerns were raised about switching off Clause 18.1 schedule 9. Operators felt that this would increase their exposure to risk, especially considering the small margins within which they currently operate. ORR responded to this by explaining that any change would only be implemented as part of new franchise agreements and so potential franchised operators would be able to factor any increased risk into their tenders.

59. Another participant suggested that charges would be unfair if they allowed competitors to attack good revenue locations i.e. target only 'money making' routes whereas the franchised operator would still have to meet particular service levels and cross-subsidises less popular routes. On the same point, another participant stressed that changes to charges should drive correct behaviour, and not, for example, just led to different operators driving empty trains around the network. ORR highlighted the findings of a recent ITS report which suggested that there would be welfare gains from having a greater element of open access on the network.

60. The disaggregation of charges was suggested by one participant who felt that this would increase transparency and provide information on the various costs which made up access charges. For example, this could be split by operating costs and renewals or by central overheads and route costs. ORR responded by noting that costs were split by routes but that a proportion of central overheads were allocated using a common metric. ORR also noted that the regulatory accounts were now being split by route and that the next stage may be to determine charges on this basis too. If the aim was to give operators information on route costs ORR suggested that this could be found by referring to the regulatory accounts rather than through more complex charges. Network Rail added that more information on route level costs will come through as part of devolution.

61. On the topic of scarcity charges, a participant commented that capacity issues may not lie with line capacity but actually in some cases with capacity in terminal stations. The participant gave examples of trains being delayed on arrival at their

terminus, potentially due to bad timetabling. On this point, it was suggested that depending on the part of the network, some issues of capacity could be resolved through improved timetabling e.g. if a station is dominated by a single operator. Whereas charges might be useful in areas where many different operators use the same stations. Another participant explained that it is not always the case that capacity on main lines is scarcer than branch lines and so this charge needs to be carefully thought out.

62. ORR commented that it would only introduce a scarcity charge if it brought benefits to the network and cautioned against creating a charge that catered for every circumstance and explained that there is a trade-off between the complexity of the charge and the number of types of issue it can resolve.

Annex A – Introductory comments from Charles Robarts, Director of Rail Strategy, Network Rail

Key points:

- PR13 was very important to Network Rail. Network Rail has committed itself to significant change, including in terms of its relationships with its customers and accountability.
- It was important for there to be clarity on what the industry is seeking to achieve. Network Rail saw value for money and providing a good service to customers as two key priorities.
- Network Rail considered that regulation should be output-based and that it should provide good incentives to encourage delivery of these outputs. Likewise, government should focus on the outputs that it wants whilst leaving the industry to focus on delivery.
- Network Rail had recently proposed improvements to the way it operated through increasing competition, contestability, greater transparency and benchmarking. It was also in favour of introducing risk capital and moving away from having a government guarantee for debt.
- Network Rail considered that it was important to have a strong confident regulator for the whole industry and which can take a whole system perspective.
- The rail value for money study (McNulty) identified a lack of innovation in the industry. Network Rail supports ORR’s proposal to consider in PR13 what can be done to remedy this.
- It was crucial that to bear in mind that the railway was a network and that its assets had long lives. Therefore, it was important to take a whole-life system approach. Network Rail had developed a new asset management strategy to improve its asset knowledge.
- Network Rail considered that the regulatory system should permit bespoke arrangements to reflect local/regional needs.
- Network Rail was delivering significant improvements to the network, including electrification in the North, the Northern Hub scheme, Thameslink and the Edinburgh-Glasgow Improvement Project, amongst others.
- Network Rail recognised the need to improve value for money and efficiency and that to do this it needed to change. It was in the process of devolving decision making and opening projects up to competition. In summary, Network Rail considered that the regulatory regime should help to facilitate the improvements that Network Rail was making to support a successful CP5 (control period 5) and beyond.