

Periodic Review 2013 First Consultation

**21 July 2011
Manchester**



OFFICE OF RAIL REGULATION

Overview of PR13

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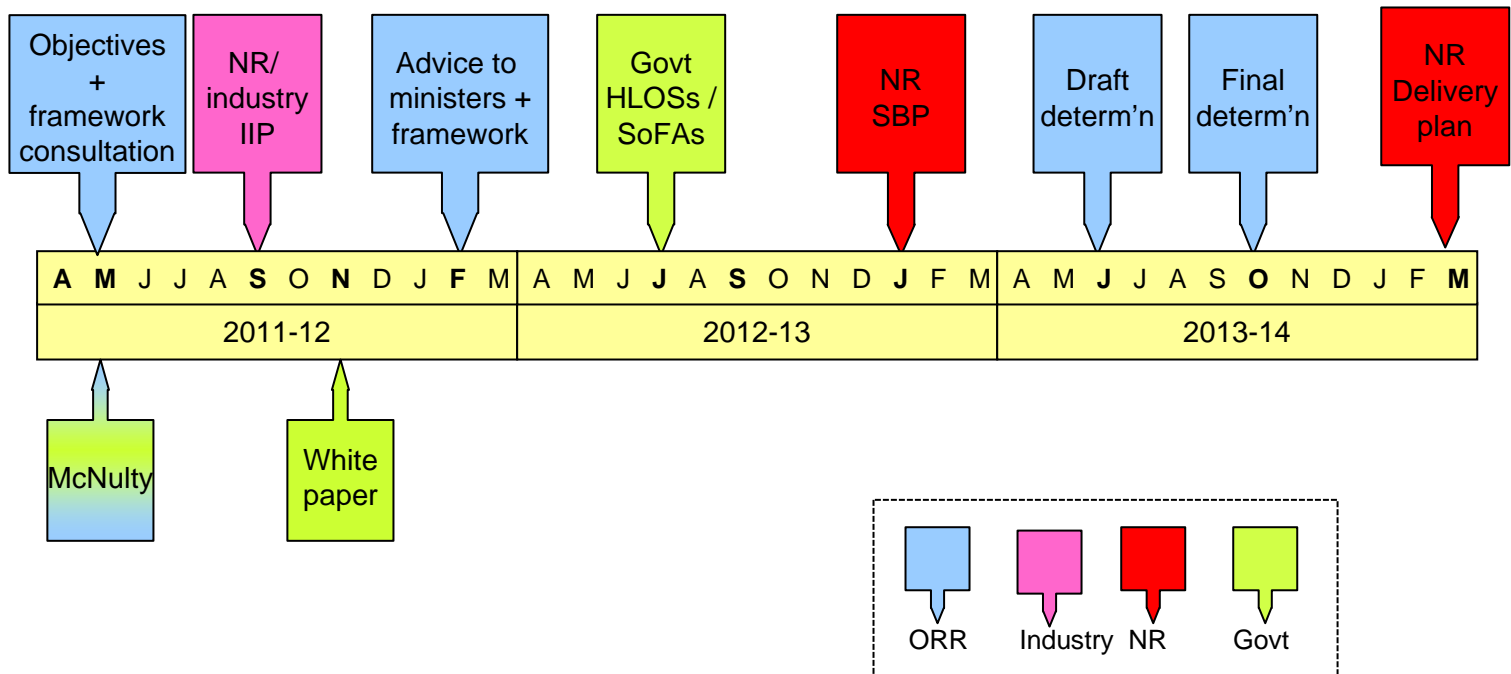


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Overview

- A periodic review is a major 2-3 year industry wide process
- PR13 applies to control period 5 (CP5): 1 April 2014 to 31 March 2019
- PR13 will establish:
 - Network Rail's **outputs** (reliability, capacity, safety, etc)
 - Network Rail's **revenue requirement** based on our assessment of its efficient expenditure and other costs and income
 - The levels of **access charges**
 - **Incentives, contractual arrangements & regulatory framework** –
- We take account of governments' "**high level output specifications**" and "**statements of public funding available**" (HLOSs and SoFAs)
- We determine outputs and revenues separately for England & Wales and Scotland
- *... this all forms a "balanced package" of judgements/decisions*

Key milestones



Undertaking PR13

- In undertaking PR13 we will:
 - Have regard to our **section 4** public interest duties (including guidance from ministers)
 - **Involve and consult stakeholders** extensively on all the key issues and proposals
 - Carry out in line with **best practice economic regulation**
- We intend to...
 - Be **output** and **outcome** based
 - Use **market mechanisms/incentives** to promote **competition**
- We will ensure PR13 is integrated into the **wider industry reform programme**
- Have **separate “price controls”** including for Scotland and routes in England & Wales

First consultation

- Our **first consultation** published on 25 May is the first key public stage in the review, with three aims:
 - Explain the timeline/process
 - Consult on our principles and objectives
 - Explain and seek views on key "regulatory framework" issues
- Key regulatory framework issues covered include:
 - Duration of the control period
 - Disaggregation of the 'price control' to route level
 - Outputs
 - Incentives
 - Structure of access charges
 - Indexation of income

Initial consultation

- We are **consulting widely** because we want PR13 to be informed by the views and experiences of stakeholders and other interested parties
- 12 week consultation closes on **2 September** – we encourage written responses from everyone who has views they would like to share with us
- We will continue to consult on key issues, such as our approach to efficiency, and on rail competition, through the PR13 process
- PR13 will be more successful with broad participation



***Shaping Britain's railways:
the periodic review in context***

**Michael Beswick
Director, Railway Policy**



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Context

- On many measures – including safety, performance and customer satisfaction – Britain's railways have never been more successful
- More passengers and freight being carried than ever before, with demand forecast to grow
- Significant investment in rolling stock and new infrastructure
- But success has come at a high cost for passengers and taxpayers – overall industry unit costs in 2009/10 the same as in 1996/97

Periodic Review 2013

- The periodic review is our assessment of:
 - what Network Rail must deliver
 - the money it needs to do so, and
 - the incentives needed to encourage delivery/ outperformance
- But it is also a major opportunity to help drive through wider step change in whole-industry performance and efficiency

Wider reform agenda

- Franchise reform
 - moving to longer, less highly specified franchises in England & Wales, with potentially a different approach in Scotland (? and the city regions?)
- Network Rail devolution
 - moving away from centralised decision making
- Wider localisation and transparency agenda
- McNulty review
 - action will be needed from across the sector to achieve positive change

McNulty: key future challenges

- **Significant cost reduction**
 - 30% in whole unit costs by 2018/19
- Clarity on **respective roles**
- More **whole system/partnership working**
- Greater **transparency**
- Greater **comparability and contestability**
- Best practice approach to **key enablers:**
 - asset management
 - project and programme management
 - supply chain management
 - safety, standards and innovation

These areas are 2/3 of savings identified
- Making **best use of existing capacity**

Levers and incentives beyond regulation

- Transparency of information/localisation of funding and specification
- Competition- potentially on rail but also comparative through benchmarking plus greater contestability of current NR monopoly elements such as stations
- Governance, management incentives and potential reform of members
- Financial structure (decisions for Government)
- NR as a network/system operator incentivized to maximize use of the network
- Partnership working and alignment of incentives between NR, TOCs, ROSCOs and suppliers.

Some key issues

- How best to align incentives between train operators, Network Rail and what governments/customers want?
- How best to improve efficiency and reduce costs to taxpayers and customers?
- How best to improve the transparency of industry costs?
- How to involve local, regional and devolved funders more effectively in the process
- How to get the rail industry to play a more effective role in planning and delivering the railway?
- How to get the best out of, and continue to develop, the existing rail network?
- How best to balance risk and reward across the industry?
- How best to deliver better value for money without compromising safety?

PR13: our overall objective

“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 to the best railways in the world by the end of the control period”

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Afternoon workshop

- Purpose: discuss key issues relating to the regulatory framework raised in our consultation...
- 1.Outputs.** Deciding on how to structure the outputs Network Rail should deliver
 - 2.Setting incentives,** including joint incentives on Network Rail and train operators
 - 3.Structure of charges** that train operators pay
 - 4.Disaggregation of price control** to Network Rail operating route level and broader **financial issues**

Outputs

John Larkinson

Purpose of this session

- Set out some of the key issues around the structure of outputs
- Discuss how to structure the outputs Network Rail should deliver as part of PR13
- Seek your views on the questions set out in our 25 May PR13 consultation document

Purpose of 'outputs' in PR13

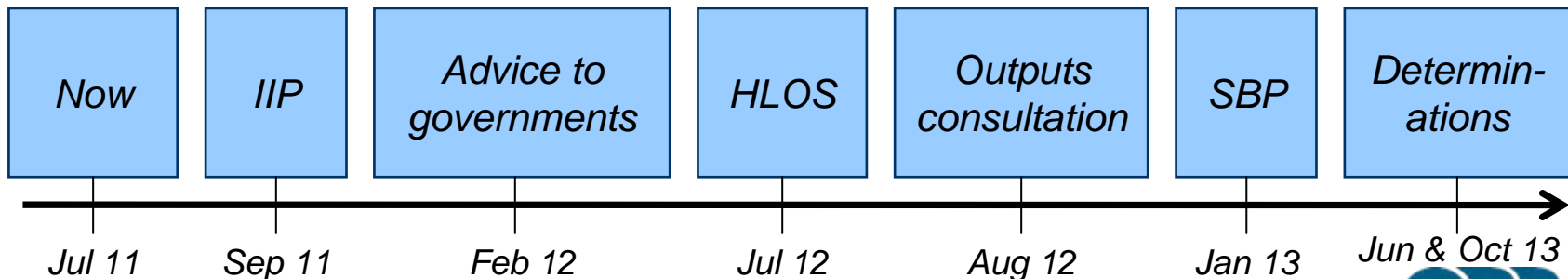
- PR13 will set (quantified) obligations on industry for CP5.
- Resulting 'output framework' will have two related aims:

Motivate industry to deliver for customers and funders



Let customers & funders know *what they can expect* from industry

- Outputs high level timeline:




What sort of output? (1)

- **Outcome, output, indicator** or **input** based measures?
→ *e.g outcome – passenger satisfaction; output – PPM; indicator – track condition; input – track renewal volume*
- **Many** measures (with performance judged in the round) or a **few** individually more significant obligations?
- **Yearly** or **end-of-control period** outputs?
- **Company specific** or **whole-system** measures?
→ *e.g company specific – delay minutes; whole-system – PPM*

What sort of output? (2)

- Use **composite indices** to reduce the number of output obligations set while capturing some of the complexity of customer requirements?
 - *e.g 'overall equipment effectiveness' used to measure utilisation of assets in manufacturing*
(= availability x performance x quality)
- **Stretching** outputs that form a key part of incentives on industry, or more conservative targets that stakeholders can be **certain will be delivered?**
- What **geographical disaggregation** of outputs would help you to plan?

Experience of CP4?



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Network Rail - success in control period 4

Introduction

- In October 2008, we set out in our CP4 determination¹ the minimum outputs we required from Network Rail. The output obligations are in two parts: top-level regulated outputs set by ORR, and disaggregated outputs defined in Network Rail's CP4 delivery plan.
- Network Rail sets out its commitments on disaggregated outputs for its train operator customers² in the appendices to its CP4 delivery plan.
- We will assess Network Rail's achievement of those outputs, expecting commitments to be delivered on time, year-by-year, whilst complying with its licences and access contracts as well as its statutory and contractual obligations. We have also specified efficiency gains to be delivered by the end of CP4.
- We see these as the minimum requirements and believe there is scope for outperformance.
- However, although success in the control period can be judged partly against these defined obligations there are other important factors. Keeping customers happy is a good indicator of success and we wish to see improvements in train operator and passenger satisfaction. Looking to the longer term we also expect Network Rail to make real progress with its key enablers - excellence in health & safety risk control, and in asset management - for an ever more successful railway.
- This note draws on all these to set out in summary terms trajectories of improvement in Network Rail's performance the achievement of which, year-by-year, would satisfy us that the company was on track.

Required minimum outputs

Safety

- The Government's high level output specification (HLOG) included a 3% reduction in the risk of death or injury from accidents on the railway for passengers and rail workers for the whole of the British mainline network over the five years of CP4 (using the industry's RSCB safety risk model).
- Network Rail has responsibility for delivering its own contribution, but not that of other parties. The company set out in its 2009 delivery plan two trajectories that will contribute to achieving the 3% reduction in safety risk as shown below.
- Year by year we will also review progress on the infrastructure component of the precursor Indicator model, our enforcement activity, progress on corrective action and recommendations, near miss

and all injury trends, safety tour feedback and the safe working index.

Safety trajectories		
	Passenger safety index (fatalities & weighted injuries per billion passenger km)	Employee health and safety index (fatalities & weighted injuries per million hours worked)
2008-09	0.258	0.137
2009-10	0.248	0.098
2010-11	0.246	0.096
2011-12	0.244	0.094
2012-13	0.242	0.092
2013-14	0.240	0.090

¹⁰ These trajectories do not have the status of customer reasonable requirements.

Passenger train service performance

- The HLOGs specified that Network Rail and its train operator partners are to deliver improvements in the public performance measure (PPM) by sector, by the end of 2013-14. The relevant national PPM trajectories are below, with the HLOG targets in bold.

Passenger train punctuality (% PPM)				
	Long distance	London & SE	Regional	Scotland (First ScotRail)
2008-09	87.6	91.2	90.1	90.6
2009-10	88.6	91.5	90.5	90.9
2010-11	89.6	92.0	91.0	91.3
2011-12	90.9	92.4	91.5	91.7
2012-13	91.5	92.7	91.9	91.9
2013-14	92.0	93.0	92.0	92.0

- In England and Wales, the government specified reductions in cancellations and significant lateness by sector. Network Rail included these trajectories in its delivery plan.

Cancellations and significant lateness (% of services affected)				
	Long distance	London & SE	Regional	Scotland (First ScotRail)
2009-10	4.9	2.3	2.8	2.0
2010-11	4.5	2.2	2.5	1.9
2011-12	4.2	2.1	2.4	1.8
2012-13	4.0	2.0	2.3	1.8
2013-14	3.9	2.0	2.3	1.7

Note: Scotland figures are Network Rail's internal targets

- We set maximum levels for the passenger and freight train delay minutes for which Network Rail is held responsible.

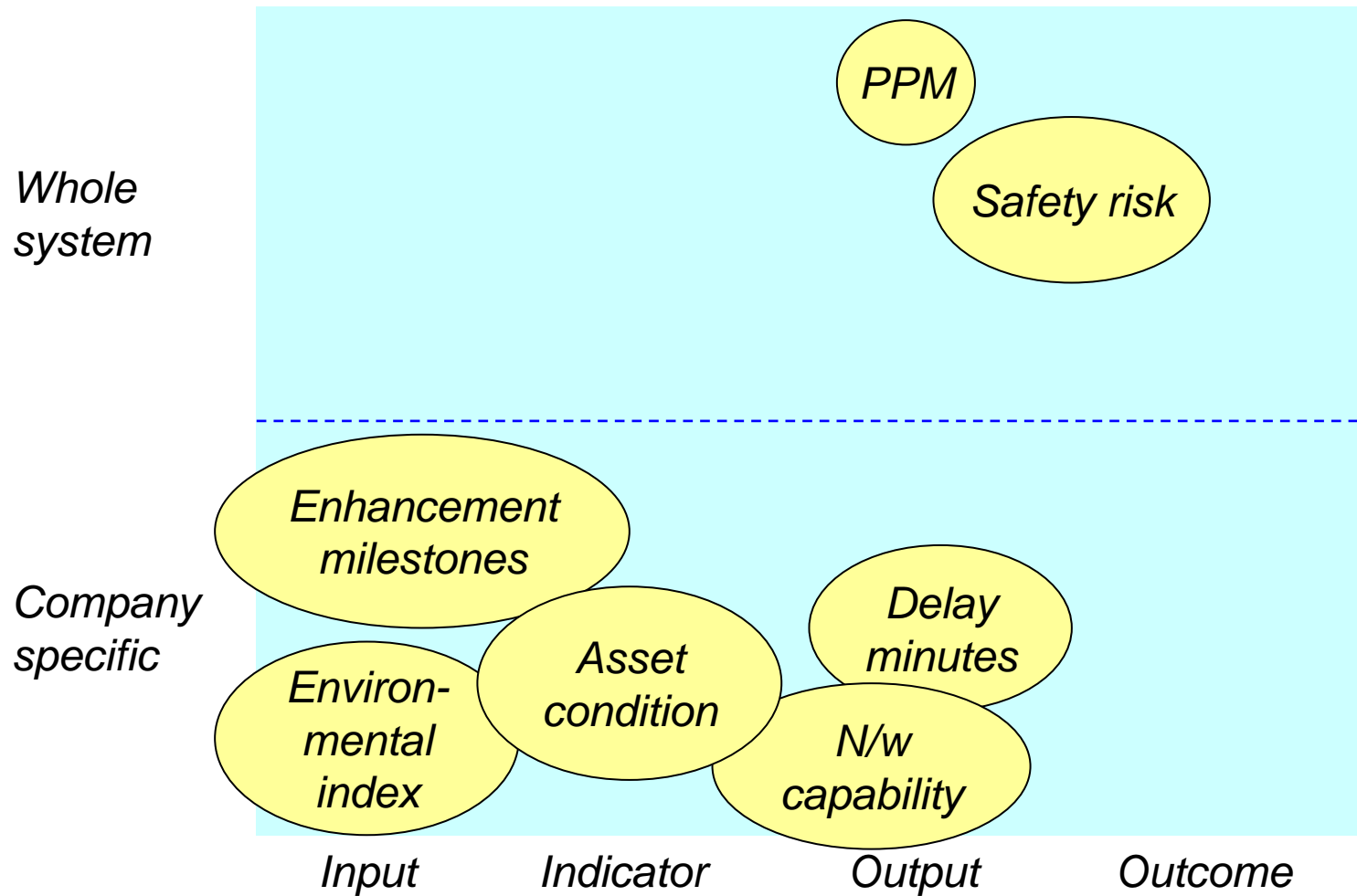
¹ Periodic review 2008 - determination of Network Rail's outputs and funding for 2009-14 (ORR, October 2008).

² See [Moving ahead - Delivering a better railway](#).

Doc # 307310.00

- Predominantly a mix of output and input based, using whole system measures where a robust process for joint delivery existed (e.g. PPM).

Experience of CP4?



Your views...

- **Outcome, output, indicator** or **input** based measures?
- **Many** measures (with performance judged in the round) or a **few** individually more significant obligations?
- **Yearly** or **end-of-control period** outputs?
- **Company specific** or **whole-system** measures?
- Use composite indices?
- **Stretching** outputs or more conservative targets that stakeholders can be **certain will be delivered**?
- What **geographical disaggregation** of outputs would help you to plan?

Outputs issues are considered in more detail in **Ch 6** of our **PR13 first consultation**, and in its **Annex C**.

Incentives

Paul McMahon

Forms of incentive

- Financial
- Licence and other legal obligations
- Reputational and other incentives

- We need to consider interaction between all incentives. In a periodic review, we particularly focus on financial incentives

- The incentives are a key part of the **overall package**

Incentives

- Network Rail's incentives for efficiency
- Aligning incentives
 - Efficiency benefit sharing
 - Exposure to Network Rail's costs at a periodic review
 - Sharing operators' costs and revenues
- Schedule 8 – performance regime
- Schedule 4 – possessions regime
- Making best use of and growing the network
- Incentives to improve industry outcomes

Network Rail's incentives for efficiency

- Overarching “RPI-X” incentive...
- A challenging ex-ante funding settlement, containing efficiency targets, for delivery of specified outputs
- Network Rail is permitted to retain benefits of outperformance
 - Rolling capex incentives, to balance incentives over time
 - An issue for PR13 is to consider whether incentives on capex and opex are balanced
- Network Rail's management incentive plan

Aligning incentives to promote industry-wide efficiency

A key theme from the value for money study

- Mechanisms to consider
 1. Sharing Network Rail efficiencies
 2. Exposing franchise operators to changes in Network Rail's costs at time of periodic review
 3. Network Rail sharing operators' costs and revenues
- Sources: vfm study and associated reports; LEK work on cost and revenue sharing

Efficiency benefit sharing (EBS) mechanism

- Currently mechanism operates at national level, but is “switched off” for franchises let prior to CP4
- Mechanism requires joint working between ORR and relevant franchise authority
- For new franchises, we are considering a EBS mechanism that
 - operates at the level of the Network Rail route
 - measures Network Rail’s operating, maintenance and renewal costs relative to PR13 baseline
 - shares around 25% of outperformance with operators
 - may also share underperformance

Exposure to Network Rail's costs at a periodic review

- Current franchise provisions are designed to insulate operators fully for changes to charges made at a periodic review
- Any such proposal requires joint working between ORR and relevant franchise authority
- Possible forms of exposure:
 - Changes in variable usage charge (reflecting wear and tear costs)
 - Changes in proportion of fixed charge (reflecting all costs)
 - Changes in proportion of OMR costs

Aligning incentives: sharing costs and revenue

Exposing Network Rail to

- changes in operators' costs
 - Network Rail is able to influence some costs, e.g. through timetabling; many operators costs are beyond its control
 - This approach requires significant oversight of operators' costs
- changes in operators' revenue
 - Interactions with volume incentive, schedule 4 and schedule 8 are important
 - Difficulties with implementation

Schedule 8 – performance regime

- Network Rail compensates each operator for losses resulting from delays and cancellations beyond the operator's control,
- It thereby reduces this substantial revenue / cost risk for operators
- It incentivises both Network Rail and operators to consider wider impacts of poor performance
- Complementary measures: targets, joint working
- Key issues for PR13
 - Whether to “turn off” regime for joint ventures etc
 - Whether rates should be set below revenue losses, so that operators benefit from improved Network Rail performance
 - Whether single payment rate per service group remains appropriate
 - Interaction with “schedule 9” of franchise – which adjusts for financial impact

Schedule 4 – possessions regime

- Network Rail compensates operators for service disruption due to possessions
- It incentivises Network Rail to minimise disruption and plan and notify possessions early
- Complementary measures: targets, joint working
- Key issues for PR13
 - Whether to “turn off” regime for joint ventures etc
 - Whether rates should be set below the operators’ financial impact, so that operators also work to minimise the disruption
 - Possible return to free possession allowance
 - Interaction with “schedule 9” of franchise – which adjusts for financial impact

Making best use of and growing the network

- Under existing structure of charges, Network Rail can have financial disincentive to accommodate additional traffic
- **Volume incentive** provides a counter-balance
- It is a lump sum payment at start of CP5 for traffic above CP4 forecast
- We wish to consider whether incentives can be improved in this area

Incentives to improve industry outcomes

- Incentives to encourage innovation and adoption of best practice
 - Vfm study proposes a rail innovation and growth team
 - Ofgem fund for innovative low carbon projects
- Incentives for greater energy efficiency
 - major changes to the charging regime for traction electricity
 - do not propose environmental charges for rail

Consultation questions on incentives (paraphrased)

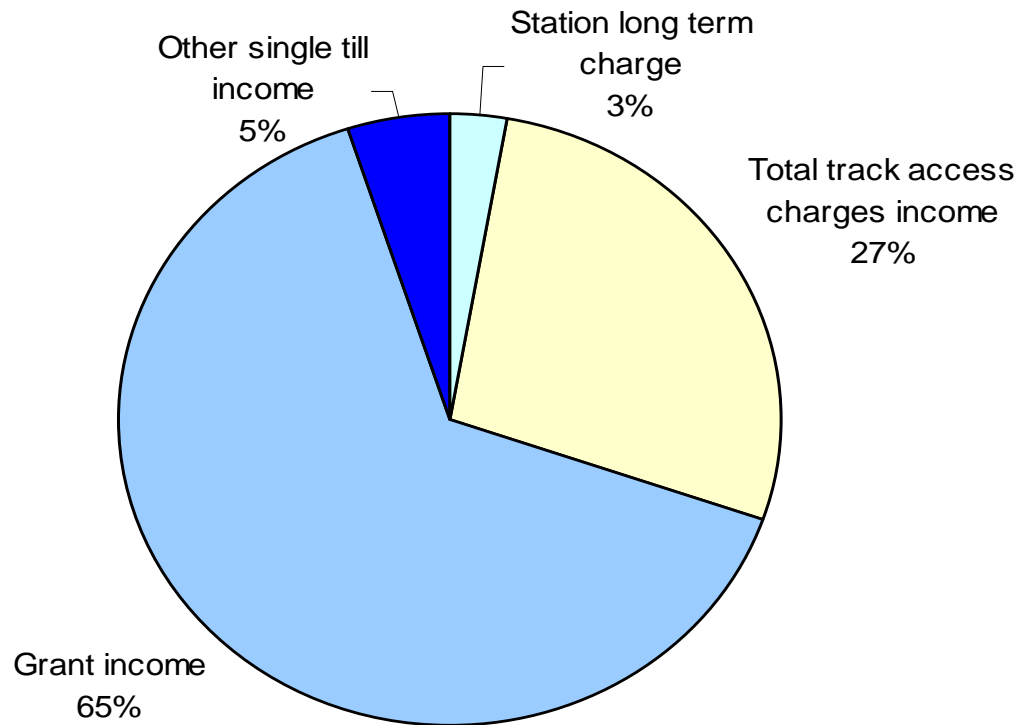
- Whether **existing financial incentives** could be improved
- Whether Network Rail's **incentives to make best use of capacity** could be improved
- Proposal for an **efficiency benefit sharing mechanism** calculated at the Network Rail route level
- The degree to which franchised TOCs should be **exposed to changes in Network Rail's costs** at a periodic review
- Whether Network Rail should share in **train operator revenue and/or costs**
- Bespoke arrangements for enhancement efficiency benefit sharing and additional measures to increase **contestability of expenditure**
- Any further **new incentives**
- Consideration of **interactions** between financial incentives and the wider regulatory framework

Structure of charges

Paul McMahon

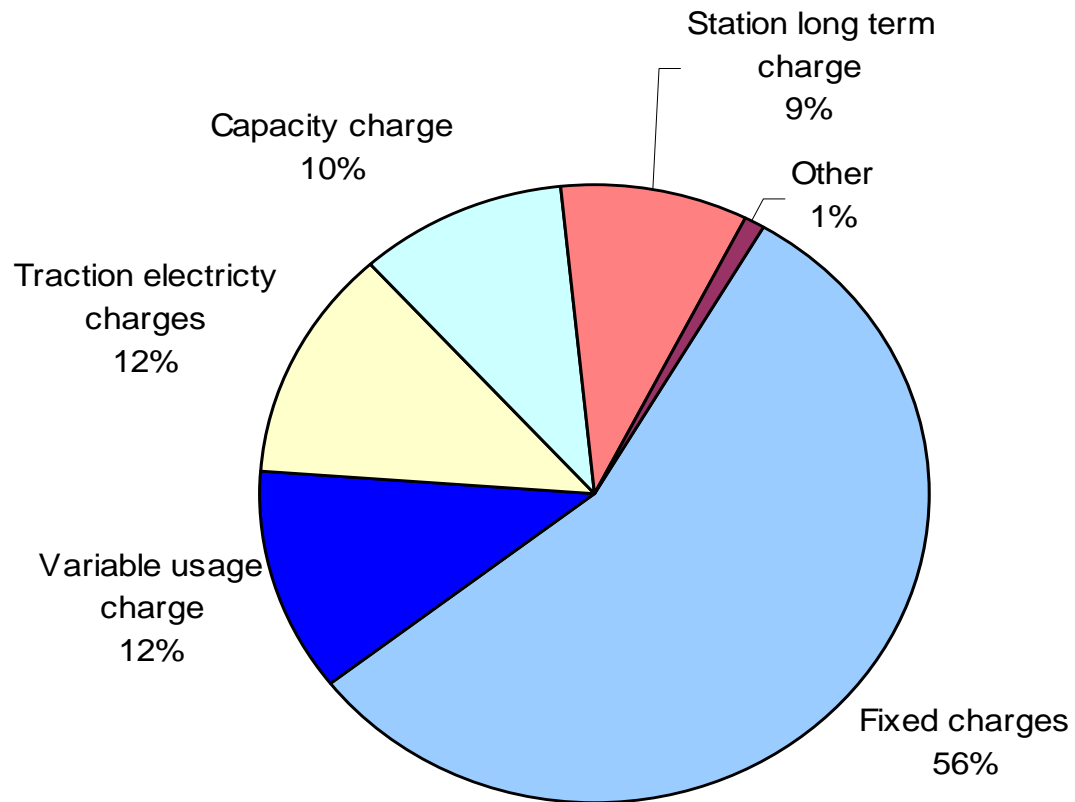
Network Rail's income (GB-wide)

Network Rail's total income in CP4 (2010-11 prices)



Charges income (GB-wide)

Network Rail's charges income in CP4 (2010-11 prices)



Roles and responsibilities for setting structure of charges for PR13

.....following an industry consultation

- We retain responsibility for:
 - setting charging objectives and guidance to Network Rail
 - developing new charge proposals
 - auditing and approval of final charges
- Network Rail to develop proposals for existing charges in line with our charging objectives and guidance

Developments since PR08

- CEPA study on possible options for charges
- ORR consultation on these options and on current structure of charges (July 2010)
- Policy developments
 - Rail value for money study
 - Department for Transport's franchise policy
- Technical developments
 - On-train metering
 - Discounts for modified vehicles

Purpose of track access charges

Track access charges provide a basis for:

- a mechanism for Network Rail to **recover the efficient costs** it incurs in providing infrastructure used by train operators
- a means to allocate costs to, and be recovered from, those that **cause those costs to be incurred**
- **price signals** to train operators, their suppliers and funders to incentivise the efficient use and development of vehicles and the infrastructure
- **incentives to Network Rail** to outperform its regulatory determination

PR08 charging objectives

- promote objectives of our statutory duties and be consistent with objectives of funders
- incentivise all participants to deliver efficient...
- ... utilisations and development of the network
- ... whole industry costs
- not discriminate unduly
- be practical, cost effective, comprehensible, and objective in operation
- be consistent with relevant legislation
- reflect the efficient costs caused by use of the infrastructure
- enable Network Rail to recover its allowed revenue requirement

Main changes that we are considering

- Geographical disaggregation of the variable usage charge
- Strengthening incentives relating to use of capacity
- Improving incentives associated with charging for electricity for traction
- Open access passenger operators contributing to meeting infrastructure fixed costs

We are not proposing major changes for station charges or freight-only charges

Variable usage charge

Current charge:

- designed to recover Network Rail's efficient operating, maintenance and renewals costs that vary with traffic
- highly disaggregated by vehicle class – incentivises track-friendly vehicles
- does not vary by location

Possible changes:

- Charge that varies according to track characteristics
- Charge that varies by Network Rail route

Charges for managing scarce capacity

- Current charges do not reflect economic value of capacity
- A scarcity charge would deliver incentives that
 - contribute to an efficient allocation of capacity on the network
 - provide Network Rail with signals about the value of accommodating additional demand
- CEPA study examined these issues, and we consulted on them in 2010
- Revisit in light of McNulty study and DfT's franchising policy – including level of detail of train service specification
- Also considering financially-neutral **reservation charge** levied for unused train paths

Open access passenger operators

- Open access passenger operators only pay variable charges
- Competition between operators can deliver important benefits for passengers....but it also abstracts revenue from incumbents' services, hence potentially funders' budgets
- Reform to the charging regime could mitigate these effects, and thereby allow us to approve a wider range of open access services
- We have commissioned a study that is considering these options
 - average cost pricing (fixed cost fully allocated)
 - peak surcharge
 - charge at "auction value"
 - charge at opportunity cost to franchise
- *We plan to publish our consultation on possible changes to the open access charging regime at the end of July*

Traction electricity charges

Current regime:

- Treated as a non controllable cost for Network Rail
- Charged using
 - modelled rates, with year-end reconciliation by geographic area; or
 - metered consumption
- On train metering is an important new development to incentivise efficient electricity consumption

Proposals:

- Encourage more on-train metering
- Incentivise Network Rail: allocate volume risk between unmetered services and Network Rail
- Allow Network Rail to recover costs for efficient levels of system losses

Early caps on certain freight charges

- Open access passenger and freight operators are fully exposed to changes in variable track access charges made at a periodic review
- Freight operators may negotiate long term contracts with certain customers: need to take account of future charges
- We are considering setting a cap on the level of certain freight charges well in advance of the final determination...possibly in exchange for a wider package for freight, relating to whole industry cost reduction

Disaggregation and financial issues

Carl Hetherington

Purpose of this session

- Discuss key issues about disaggregation of financial information and the price control to Network Rail operating route level and broader financial issues
- Seek your views on the questions set out in our 25 May PR13 consultation document

Accounting separation and financial transparency (1)

- Network Rail devolution
 - Network Rail is devolving management responsibilities to an operating route level to improve its responsiveness to customers at a local level
 - This devolution will be supported by the publication of operating route level financial information
 - This information will be audited and published for 2011-12 onwards
- The value for money study recommended the publication of regionally disaggregated whole rail industry revenues and costs to help:
 - inform decisions on the future structure of the rail industry;
 - improve industry planning;
 - improve partnerships and co-operation within the industry;
 - facilitate regional efficiency and revenue sharing mechanisms; and
 - support increased route level accountability and decision making.

Accounting separation and financial transparency (2)

- Work to date on accounting separation and financial transparency
 - We have introduced a requirement for Network Rail to prepare regionally disaggregated financial information for Wales, Merseyside and each operating route for 2010-11
 - These statements will be audited and published from 2011-12
- Next steps
 - We have had discussions with DfT, Network Rail, ATOC and train operators about developing and publishing regional whole industry financial statements
 - Our aim is not to develop complex whole-industry financial statements (e.g. P&L accounts or balance sheets) but for the industry to develop and publish a subset of key financial information to help improve understanding of regional railway performance
 - A number of issues will need to be resolved (e.g. what financial information to include) and how to present information geographically across regions
 - Our current aim is for a first annual publication (of 2010-11 numbers) in early 2012

Price control separation (1)

- Regulatory price controls serve a range of purposes including: providing the ability to undertake benchmarking, transparency, incentives and accountability
- Price control separation by geography already exists for Network Rail with largely separate controls for England & Wales and Scotland
- Separate controls also exist for passengers and freight and track and station access

Price control separation (2)

- Separate controls for England & Wales and Scotland already involve:
 - separate outputs and revenue requirements (including RAB, debt, expenditure)
 - separate provisions for dealing with risk and uncertainty (although the framework is largely the same)
 - separate monitoring and enforcement
- For PR13 we will review this approach to see if we should go further, e.g. separate efficiency assumptions for Scotland
- We are also considering whether to introduce some form of geographical price control separation by operating route (for England & Wales)

Other aspects of the financial framework (1)

- Risk and uncertainty
 - Aim is to allocate risks to Network Rail where it is best placed to manage them
- Inflation
 - To what extent should Network Rail be compensated for inflation risk (general inflation and input prices)?
- Re-openers
 - Are the current re-opener mechanisms appropriate for CP5?
- Length of the control period
 - Is the current five year period appropriate?

Other aspects of the financial framework (2)

- Unsupported debt
 - Should Network Rail move now to issuing debt without the government guarantee (PR08/CP4 policy)... If so, what provision is made for further developments in CP5?
- Amortisation
 - We plan to retain the same high-level approach to amortisation in CP5 that we introduced in CP4. What are your views?