Response by Arriva to ORR consultation on Periodic Review 2013, First Consultation, May 2011

This response is by Arriva plc, Arriva UK Trains Limited and its franchised train operating subsidiary companies Arriva Trains Wales, Chiltern, CrossCountry and LOROL (part-owned) to the proposals set out in the consultation dated 25 May 2011. We are pleased to set out below our comments on the questions in the document.

Q1 Do you agree with our proposed objective for the review? If not, what issues would you add or subtract?

We agree with the general principles, however, we consider there should be a more explicit reference to ORR's statutory duty toenable persons providing railway services to plan the future of their businesses with a reasonable degree of assurance.

Q2 Do you have any views on our proposed timetable for the review? Do youneed further information to plan your involvement with PR13?

Not at present.

Q3 Do you think that our approach to the disaggregation of Network Rail financial (and other) data to operating route is appropriate? Is the information we are requiring Network Rail to produce set at the right level?

We consider it useful but insufficient. We observe that some NR routes are large and incorporate varied networks with different train operations. Hence we consider that for some routes there should be further disaggregation, for example to show expenditure for Marylebone-Aylesbury/Aynho Junction separately from the rest of the route. We are also concerned that there appears likely to be a very large overhead imposed on routes for central NR activities. We would like to see greater transparency in these and the opportunity for routes to consider other suppliers or variations in standard national processes where beneficial.

Do you have views on the information train operators should produce?

We do not consider it necessary or appropriate for train operators to provide information in relation to a regulatory review of the infrastructure manager's charges. It would be different if trains were operated by regulated permanent entities, but that is not the current or envisaged structure, and we strongly object to any introduction of double jeopardy on the winners of competitively let franchises. Such information as may be necessary to form a view of whole industry costs is available to the client bodies (mainly DfT) which let and manage the franchises.

Q4 Which aspects of the price control should be separated for England & Wales and Scotland, e.g. should the efficiency assumption be separate?

We consider a key aim of devolution is to incentivise local efforts to improve efficiency, so, to the extent costs can be separated or that efficiency can be achieved locally, the outcome should fall locally. We would also wish to see efficiency assumptions brought to bear on overheads and these will have to be dealt with on a whole of NR basis.

Q5 Do you think there should be further separation of the price control forNetwork Rail's operating routes and, if so, which aspects of the price controlshould be separated?

See answer to Q4. We recognise that some flexibility for over and under achievement of local targets may be reasonable within a national target, but do not believe it is fair to access charge-paying customers and end-users that this flexibility is unlimited (through having only national targets).

Q6 Is the current approach to defining obligations in terms of outputs the bestapproach? What outputs should be defined? Should there be a move to moreuse of outcome based obligations. Would another approach be appropriate?such as specifying inputs or intermediate measures?

We support the current approach of defining output obligations.This does need to be backed by a willingness and ability to intervene to review whether processes are in place that are reasonably likely to deliver such outputs, particularly where an operator expresses a reasonably founded complaint that this is not the case.

Q7 What are your views on how we should compile and present 'scorecards' of Network Rail's performance in CP5?

We would like to see these devolved to route level. We believe further attempts should be made to find suitable measures in relation to network availability and journey times as these are central to the earning capability of the access purchased by users.

Q8 Should we make more use of 'whole system' outputs over which Network Rail does not have full control, or focus on more narrowly defined outputs which the company is fully responsible for?

In general we believe it is appropriate to pick outputs that are solely the responsibility of NR. PPM is useful exception to this approach because NR plays a central role in coordinating collective industry action over many (but not all) factors affecting its delivery.

Q9 How should output obligations be defined in the context of devolved Network Rail routes with separate price controls?

We consider that wherever possible obligations should be set by devolved route. We do however recognise that some flexibility for over and under achievement of local targets may be reasonable within a national target, but do not believe it is fair to access charge-paying customers and end-users that this flexibility is unlimited (through having only national targets).

Q10 How should the balance between the number of output obligations and their individual significance be struck?

Greater weight should be given to those outputs that have real financial value. This will facilitate whole-industry cost reduction as sought by the Government.

Q11 Should Network Rail's output obligations include a specific safety requirement, different from its legal obligations?

In view of the safety performance now being delivered we see no continuing need for regulatory safety targeting beyond legal obligations.

Q12 Do you have views on how the effectiveness of the existing financialincentives can be improved?

We believe there is a substantial problem with the current incentives framework in that NR appears to be over-incentivised to deliver a network that works properly and under-incentivised to grow business on it. As a result its decision making on timetable planning, possession planning, renewals and enhancements err to the over-cautious and many opportunities to grow business have been missed. This is compounded by the complex, national and longer term nature of some incentives, so that even where mechanisms exists (e.g. the volume incentive and Schedule 4), their workings are not well enough understood or devolved to the people who need to be incentivised.

Q13 Do you have views on how the effectiveness of Network Rail's incentives to make best use of capacity could be improved?

We consider NR has not been effectively incentivised in this area. Its approach to timetable planning has been incremental and very conservative. It has been surprisingly reluctant to use its flexing rights to increase use of capacity. Whilst it is correct to consider carefully the performance implications of change and in particular intensification of use, the result has been a network of services that earns less revenue and carries fewer passengers (and possibly less freight too) than would an optimised network. Repeated reorganisations of the planning function, shortages of proficient planners and the new ITPS have exacerbated this problem.

We consider the RUS process has become more effective, although there is still a problem that producing each plan to the regulated deadline appears to have a greater priority than finding a route solution that maximises business.

Q14 Do you agree that we should include a regional efficiency benefit sharingmechanism calculated at the Network Rail route level?Are there further issues about how a regional efficiency benefit sharing mechanism should be introduced which you want to highlight?

Yes, but consideration would need to be given as to how this would work for operators using a number of routes, notably CrossCountry and the freight companies.

Q15 What are your views on exposing franchised passenger train operators tochanges in Network Rail's costs at a periodic review?

This is a difficult area, as in principle it is clearly beneficial for a customer to be exposed to a supplier's costs as it leads to active engagement in those costs and incentivises joint efforts to control them.However, we have to recognise that the franchised part of the British rail industry is far from a normal industry:

- NR is a monopoly supplier, there is not even a domestic comparator
- NR does not have conventional ownership with the discipline of equity
- Franchised TOCs are numerous and individually weak in comparison
- In other industries a change in supplier's costs will generally lead to some combination of reduction or increase in production, changes in prices, closing or opening outlets, changing supplier, starting supply production in-house or in extreme

closing down. All of these are prevented by the franchise agreement (except in the latter case with very substantial penalties)

- Current franchises were let on the basis that franchisees would not be at risk for NR costs
- Future franchises could be let with that risk, but it would incur a major cost in view of the need to engage in enormously more detail in future periodic review processes and the substantial risk arising from inability to subsequently change its own prices and outputs.

We can envisage a whole series of structural changes to the industry that might enable this course of action to be reasonable, but these would be well beyond what appears to be contemplated post-McNulty. We, therefore, conclude that the only practical route is a more limited “upside-only” efficiency share to encourage collaboration in cost-saving.

Q16 Do you believe that Network Rail should share in train operator revenue and/or costs? Are there further issues about introducing a revenue/costsharing mechanism which you would highlight?

We are unaware of any precedents in other industries for such a course of action. In other industries suppliers make more money by selling more and/or better products to their customers, in line with what those customers want in order to satisfy end-users, not by levying their income. There is already a substantial problem within franchised train operators of creating an environment in which investment and change is worthwhile. Hopefully this will be improved by the Government’s proposed franchise reforms. We would see NR sharing TOC revenue as a move in the opposite direction, reducing incentives for TOCs.

Q17 We would welcome your views on possible bespoke arrangements forenhancement efficiency benefit sharing and whether there is a need foradditional measures to increase the contestability of expenditure?

We are very concerned that enhancement costs are unusually high for projects undertaken by NR, but efforts to use other implantation models can be hampered by NR’s approach to acceptance, application of standards and long-term asset protection policies. We are also concerned that within a single till enhancement income might be diverted to other activities or include disproportionate overhead. We would therefore welcome measures to ring-fence enhancement spend, introduce contestability and incentivise efficient achievement of useful outputs.

Q18 Are there further new incentives which you believe should be introduced and what would the benefits be?

As indicated above, we do not consider NR to be sufficiently incentivised to maximise use of capacity, improve journey times or reduce possessions.

Q19 Are there other interactions between incentives (and the wider regulatoryframework) which we need to take into account?

The main challenge with interactions is to take account of the differences in financial framework and robustness of currently franchised TOCs, newly franchised TOCs, open access operators and freight operators.

Q20 What are your views on the duration of the control period?

We have not seen any evidence or argument to support a change from five years.

Q21 Do you think that we should retain the single till approach rather than moving to a dual till approach?

On balance yes.

Q22 Do you think that our overall approach to risk and uncertainty in PR08 was appropriate and are there any improvements that could be made for PR13?

Yes, and we have no specific suggestions.

Q23 Network Rail faces a number or risks. At this stage, do you have any views on how general inflation risk and input price risk should be addressed?

We consider that NR has substantially more protection from inflation risk than most commercial organisations, as a result of its monopoly position, lack of conventional ownership and the periodic review pricing process, and see no need for any new provision.

Q24 We plan to retain the same high-level approach to amortisation in CP5 that we introduced in CP4. What are your views?

We do not seek any change.

Q25 Do you consider that our charging objectives remain appropriate?

Yes.

Q26 What are your views on the geographical disaggregation of variable usage charges?

We would support this in principle if there are in fact material differences in actual variable usage costs. We are aware that this is a field in which it has proved difficult to establish robust evidence and, given the time remaining, believe it is unrealistic to do so for CP5. This issue could be explored during CP5 with a view to consideration in PR18. In this context we note that the issue probably most needing more research is probably the extent to which renewals are caused by traffic and what characteristics of that traffic either bring forward or delay renewals.

Q27 What are your views on introducing a charge levied to reflect networkscarcity?

We believe it would be very difficult to devise a mechanism that did not give rise to perverse incentives or amount to a system to price off growth whilst rewarding NR for doing nothing to accommodate it. In particular, whilst we can envisage in principle how it might potentially work if all trains were open access, it is very hard to see how it can co-exist with franchised operations.

Q28 What are your views on a reservation charge (assuming it would be set to be financially neutral for freight operators)?

We consider this would probably be beneficial, as whilst we appreciate freight operators need some spare paths to accommodate short term and fluctuating demand, we consider too much capacity is sterilised by unused paths at present and some financial incentive would be appropriate. It would logically be introduced initially at a relatively low level to give time for freight contracts to adapt and considered again in PR18.

Q29 Should passenger open access operators pay charges that exceed variable costs. How should charges be calculated?

Scope for such an initiative is materially constrained by European railway law and past legal judgement. An arbitrary “jam-spread”, whether of the direct grant to FTACs or the fixed element to VTACs, even if lawful, is likely to throw up a host of destabilising incentives, when the focus of the industry needs to be on net cost reduction.

Whilst there are issues to review, as mentioned under Q26, of the causation of renewals, which might provide a basis for medium-run variable cost charging (for all operators), we do not believe the necessary data currently exists. We conclude that PR13 should continue to base VTAC on short-run variable costs.

We are concerned, however, about the poor incentives on NR to behave like a normal supplier and try to sell more/better products. It would therefore be worth considering whether VTACs (for all operators) should include a small “profit” to NR, say 3-4 per cent, over the identified short-run costs.

Q30 What are your views on the proposals to improve incentives to reduce traction electricity consumption?

This change is supported in principle, but care must be taken that it really incentivises energy saving and not gaming the allocation of unmeasured consumption. We believe it is also very important to incentivise NR to reduce transmission waste, a cost which they pass in full to operators and currently have no incentive to tackle.

Q31 Should we put a cap on certain freight charges in advance of ourdetermination and should these be linked to other changes?

We acknowledge that the nature of the freight business and high level of highway competition make it appropriate to avoid undue price shocks at each single periodic review. We would have no objection to limits of deviation being set out early, but believe the periodic review should still reach its conclusions in due course, even if some changes are held over to a future date, so that future business decisions can be taken with this knowledge.

Q32 Do you have views on the interactions between these possible changes and when they should be implemented – for example whether some changesshould only be introduced after other changes have 'bedded in'?

Reference is made to the possibility of increasing the fixed charge and reducing direct grant or the benefit in principle of all NR’s costs being supported by charges on customers. Whilst this seems an attractive concept in principle, it is totally unacceptable when those customers have not been able to specify NR’s outputs and control its renewal and enhancement programme.

Specifically, we note that since the formation of NR, Governments have directed it to do various schemes and to use DfT’s social cost-benefit evaluation model to make certain choices between projects. We believe that these amount to Public Service Obligations (under European railway law). In most other European countries such expenditure would be covered by Government grant. We recognise the RAB system is an efficient funding mechanism, but consider the debt charges arising from such expenditure should be met by Government and not allocated to customers.

We note that changes to franchising are proposed by Government, but few details are yet available. It will be important for ORR to consider the impact of PR13 on the next round of franchise competitions, especially if it were to turn out that these do not have the same protection from periodic reviews as has been the case to date.