

Richard Gusanie  
Office of Rail Regulation

Sent by email to:  
richard.gusanie@orr.gsi.gov.uk

6 September 2011

Dear Mr Gusanie,

### **COMMENTS ON ORR PERIODIC REVIEW 2013 – FIRST CONSULTATION**

I am writing to you in response to the ORR consultation document of May 2011, which invited comment on the proposals for the 2013 periodic review (PR13).

First of all, however, the Government plans to publish a detailed policy statement later this year setting out its plans for the rail industry in respect of rail reform. You will appreciate that thinking is not yet finalised on all aspects of rail reform, and it may develop beyond the views expressed in this letter, either to go further, or in the detail.

#### ***Objective for PR13***

The Government is content in general terms with the process and objectives set out in the consultation document. These reflect the successes and the lessons learnt from the 2008 periodic review, and the discussions across the industry to date on the reforms required to deliver a lower-cost railway.

The document rightly emphasises the vital importance of the rail industry reducing costs and delivering better value for money, as identified in the study led by Sir Roy McNulty. PR13 will be financially challenging for the industry. A robust approach to unit cost reduction will be essential for underpinning future investment.

Substantial rail expenditure has already been committed for Control Period 5 (CP5) on projects such as Thameslink, the Intercity Express Train and route electrification on the Great Western and in the North West. The scale of the fiscal deficit means further investment will be hard won. The use of the railway has increased substantially in Control Period 4 (CP4) and this growth is forecast to continue but the industry must deliver cost reductions if railway itself is to continue to grow.

#### ***High Level Timetable***

The provisional high-level timetable is satisfactory and, on the basis of this timetable, the Secretary of State for Transport will publish his High Level Output Specification (HLOS) and Statement of Funds Available (SoFA) by 31<sup>st</sup> July 2012.

Early decisions on areas of the regulatory framework where consultation shows a consensus would be helpful in enabling industry parties to plan with confidence. For example, whilst it is appropriate to examine the duration of the control period, the original reasons for maintaining a five year control period still appear valid. We have recently set out a revised programme for franchise re-letting and if the ORR were able to confirm the control period duration early, it would facilitate greater investment certainty.

Similarly, early decisions around the management of the carry over of expenditure from CP4 to CP5 are likely to help ensure efficient delivery. A number of major enhancement projects already span the control periods; others may need to do so because of a change in circumstances.

### ***Price control separation and Network Rail devolution***

The Government is strongly in favour of data transparency, including costs, and agrees the principle of disaggregation of financial and other data to operating route level. We have already made public more data such as the rail demand and capacity for major cities and will continue to do so.

The Government endorses the emergence of more devolved accountancy, with opportunities for financial alliances between operators and Network Rail, and with greater clarity of cost for parties wishing to invest in the railway. The Government supports decentralisation and is exploring what can be done at a more local level within the regions. We expect to consult on these issues late this year.

In order to support train operators and Network Rail working together effectively at local level to reduce whole system costs, Government would strongly encourage the ORR to consider setting access charges on a route basis.

### ***Outputs***

The provision of a safe railway continues to be a key requirement of the Government. Clarity of safety requirements is essential. In 2009 the safety specifications in the first HLOS were supplemented by the provision of the European Common Safety Targets and National Reference Values. The Government will consider industry advice on the appropriateness of continuing a separate safety requirement in the forthcoming HLOS.

We support the principle of output-based obligations that set a measurable goal but provide flexibility of delivery. The Government has committed to longer term and less prescriptive franchises that follow this concept. Shared 'whole system' outputs are of substantial use in encouraging efficient behaviour but it is important that these are industry led and not dominated by one party. The development of the Strategic Freight Network is a good example of how 'whole system' outputs can work well.

In considering the balance of output obligations it is important to give consideration to the 'whole system – whole life' costs of activities, to ensure industry efficiencies are given precedence over individual parties. Revenue generation opportunities should be considered alongside cost savings when renewal activities are planned. For example, higher line speeds may be practicable at little additional cost if signalling and track

renewals are aligned and the resultant faster journey times can generate extra operator income.

### ***Incentives***

Incentives should focus the whole industry on value for money, cost reduction and the scope to increase revenue. It is important that the incentive mechanisms developed are capable of being readily understood by commercial managers so as to drive the right actions.

An important element of improving value for money is making the best use of existing assets to maximise revenue. To this end, it is important that Network Rail has the right incentives. The volume incentive proposed for CP4 was in part designed to meet this need and we would encourage the Regulator to look again at this area with the benefit of that experience.

In developing financial incentives it would seem helpful that Network Rail develops its understanding of the needs of the end users through the train operators, as well as the likely effect on the supply chain, smoothing demand as far as is efficient.

The Government is conscious of the work the ORR has undertaken on developing a regional efficiency benefit sharing mechanism and is supportive of this. We will also continue to work with ORR and others to consider whether there is a case for partially exposing TOCs to changes in track access charges at regulatory review.

Government will look for a sizeable element of the cost reduction benefits to flow back to the taxpayer through reduced subsidy. There may be differing incentives on franchise train operators depending on the extent to which they are likely to develop to cover their full costs. We would ask ORR to keep the options on incentives open for now whilst industry work continues on incentive alignment, and to have regard for existing and future franchise contracts, which may affect the extent to which ORR is seeking any incentive.

### ***Financial framework***

The basic financial framework has proved robust and flexible in CP4 and we do not currently envisage a need for structural change.

The pricing of Network Rail financial risks needs to have regard to the overall fiscal challenge Government faces, the extent to which Network Rail is realistically exposed to risk and the extent to which it is actively seeking to reduce risk and increase efficiency in collaboration with the wider rail industry. We will continue to discuss these matters and the framework for Government financial support with the ORR, Network Rail and industry parties in preparation for the February 2012 consultation.

### ***Structure of charges***

It is important that charging mechanisms are readily understandable with a transparency of charges and with pricing mechanisms that are reflective of the commercial reality and drive the right behaviours. In this regard, we would encourage the regulator to think about the pricing of scarce capacity, as allowed for under the relevant EU legislation.

The early determination of the structure of freight charges in PR08 was widely welcomed by the UK logistics industry as providing the certainty and stability necessary to stimulate continued investment in business growth and we would encourage ORR to seek to replicate this win in PR13.

***Conclusion***

We trust these comments help you in developing the structure of the periodic review and we look forward to continue to engage with you and the wider rail industry in developing better structures and incentives to enable affordable growth of the railway.

Yours sincerely,

**NICK BISSON**  
**Director of Rail Policy**