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Dear Richard,

Periodic review 2013: Consultation on incentives

This letter forms the Department for Transport's response to the Office of Rail Regulation's periodic review 2013 consultation on incentives, launched in December 2011. It summarises the views of the Department in respect of key elements of the consultation document. Many of the points covered here have already been the subject of extensive discussions between our officials. These productive discussions should continue as our thinking develops.

Aligning the incentives of track and train

The Department considers alignment of incentives between Network Rail and train operators to be a core element in the drive to reduce the rail industry's costs for farepayers and taxpayers, and a critical part of the response to Sir Roy McNulty's *Rail Value for Money Study*. Incentives should focus the whole industry on value for money, cost reduction and the scope to increase revenue.

DfT believes that aligning incentives fits with better regulation principles by giving train operators and Network Rail the incentives to pursue efficiencies without micro-managing delivery. DfT welcomes the ORR's proposals to introduce incentives that will give train operators an interest in Network Rail's operating, maintenance and renewals (OMR) costs including:

- exposing TOCs to NR out- and under-performance against NR's efficiency target within a control period (the ORR's proposed Regional Efficiency Benefit Share Mechanism); and
- exposing TOCs to a proportion of the change in Network Rail's OMR at periodic review.

DfT intends to make the necessary changes to new franchise contracts to turn on these incentives, though will want to consider the total degree of exposure and the impact on the risk profile of a TOC.

It is clear that a number of issues raised over the course of the consultation period will need to be addressed, including but not necessarily limited to;

- The interaction between the above mechanisms and bespoke arrangements for partnership working developed between individual TOCs and Network Rail;
- The need to uphold principles of fair access and competition, ensuring that incentive mechanisms do not prejudice the interests of minority passenger and freight operators;
- Ensuring that both Network Rail and TOCs are incentivised to minimise the effect on passengers and freight customers of planned and unplanned disruption to services; and
- Protection of taxpayer and farepayer interests, and the scope for taxpayers and farepayers to share the benefits of improved partnership working.

We will engage further with the ORR over the coming weeks and months on these issues.

Furthermore, to avoid unnecessary uncertainty and to maximise franchise value, it will be important for the ORR to give early clarity over the design of the mechanisms. Provision for the ORR’s Efficiency Benefit Share mechanism has already been made within the West Coast franchise ITT. While future franchises will be developed on a case-by-case basis, we will look at the potential to expose train operators to both the mechanisms set out above. The DfT is also keen to continue to explore with the ORR and the industry the potential for bespoke arrangements and how these could interact with the proposed mechanisms and franchises. We look forward to continuing discussions with the ORR and the rail industry on the rail reform agenda as it develops.

DfT also supports ORR’s consideration of incentives to give Network Rail an interest in passenger and freight train revenues and/or volumes and will be keen to engage further as proposals are developed.

As regards freight, DfT believes that proposals for geographic disaggregation of variable usage charges must avoid adding to the regulatory burdens and thus transaction costs on freight operators and on other operators using more than one route. We support ORR’s proposals to publish an early cap on the overall level of certain freight charges and to investigate the scope for mark-ups on variable usage charges, subject to what the market can bear.

We share the ORR's concern both at the potential distortion of road and rail competition and the regulatory burden which would arise for both rail operators and infrastructure managers from mandatory noise related track access charges.

Schedules 4 and 8

The Department agrees with the ORR that Schedules 4 and 8 do not require fundamental change, but that refining these incentives has the potential to result in better outcomes on performance and on possessions.

In particular, DfT believes there may be scope to improve partnership working between NR and TOCs by reducing the financial value of the incentives, including by not compensating TOCs fully for disruption. However, in devising any mechanism it will be important to:

- avoid material reductions in the incentives on NR to improve performance;

- minimise the frustration caused to passengers by bus substitution; and
- consider the approach to compensation for external events, such as cable theft or severe weather, and for TOC on TOC delays.

DfT is also interested in the concept of a time lag on Schedule 8 payments, in order better to reflect the revenue impact from poor performance.

Finally, we support ORR's plans to review the payment rates for the incentives in order to minimise the risk that train operators are under- or over-compensated for delay.

Capacity utilisation

DfT supports the ORR's consideration of options to make best use of capacity on the rail network, particularly where such capacity is scarce. We note that there are challenges around the introduction of scarcity charges. Nonetheless, if demand for rail travel continues to grow as expected, it will become increasingly important to factor into decision-making the economic value of alternative uses of capacity.

NR financial framework

Turning to Chapter 8 on Network Rail's Financial Framework, DfT welcomes the clarity provided by setting out some of the options for assessing different approaches to Network Rail's cost of capital. DfT agrees with the proposed criteria for assessing different approaches to Network Rail's cost of capital. These criteria reflect the Government's desire to reform the rail industry in order to make it more sustainable and reduce the burden on the taxpayer and the farepayer.

Whilst all of the criteria are important, DfT believes that changing the treatment of the cost of Network Rail's capital has particularly significant implications for affordability and for the flexibility to accommodate changes to Network Rail's financing structure. With regard to affordability, the Government's priorities are to tackle the deficit and to promote economic growth through capital investment. DfT is therefore keen to ensure that the approach to the cost of capital maximises opportunities for such payments to be used for economic growth. Further, the approach to all charges on the RAB should reflect the need for growth in the RAB to be sustainable in the long term.

With regard to flexibility to accommodate changes to Network Rail's financial structure, DfT agrees with ORR that the impact of changing the approach to the cost of capital should be considered over the longer term. DfT also agrees that any approach should not rule out the possibility of introducing equity into all or part of the company at a later date.

Having considered these factors, DfT believes that ORR should consider in more detail options which reflect the lack of equity within the current model, whilst preserving opportunities to introduce equity in future. DfT will be discussing these factors with ORR, Network Rail and the rail industry in advance of the publication of the HLOS and SoFA.

Innovation

The independent *Rail Value for Money Study* (May 2011) noted that GB rail innovation has lagged behind other railways, other transport modes and other industries. DfT considers that further measures to incentivise innovation in the rail sector are required. We have started discussions with ORR on how best to incentivise the industry in improving innovation. The relevant cross-industry group (the Technical Strategy Leadership Group) has also started parallel discussions with the ORR, which we welcome.

Particular consideration is needed for innovation requiring collaboration between different parts of the industry (rather than just within Network Rail's own innovation programme).

Environment

On environmental incentives, DfT supports the ORR's desire to incentivise operators and Network Rail to reduce electricity consumption. In particular we support further incentives to encourage or require train operators to fit energy meters to electric trains. This not only makes sense in terms of encouraging operators to implement energy efficiency measures but it would also provide Network Rail with better information on the pattern of electricity consumption and the level of infrastructure losses.

Whilst we agree that Network Rail should manage its electrification network efficiently, the opportunities for it to reduce electrification losses cost effectively on either the AC or DC networks currently appear limited. Consequently we view this area as less important than encouraging the fitment of meters on trains.

We note that if your consultation proposals constitute a change in the structure of electricity charges, they could fall under the scope of the Franchise Agreement Schedule 9 process. In such a case a financial adjustment would be made to franchise payments to reflect the change (at least for current franchises). DfT would then receive any financial benefit rather than the TOCs, which would reduce the incentive for them to assist in developing such a mechanism.

An alternative approach would be to keep the structure of EC4T charges unchanged but only allow Network Rail to recover costs for an efficient level of losses. The difference between what the TOCs paid, which would cover actual system losses including any inefficiencies, and the costs that NR could recover might then go into an industry energy efficiency fund. This could be used to fund TOC initiatives such as installing energy meters on trains or potentially other measures such as driver advisory systems or rolling stock modifications. We would be happy to discuss such an initiative in more detail with you.

Yours sincerely,

NICK BISSON