Periodic Review 2013: Consultation on Incentives East Coast Response

Q3.1: Do you agree that in PR13 we should focus on incentivising delivery of outcomes that customers, wider society and funders value?

Yes.

Q3.2: Do you agree with our assessment of the outcomes that customers and society value?

Yes. In addition to the passenger outcomes listed, we recommend an outcome based on satisfying reasonable growth expectations. There is a risk that profitable demand will be frustrated if additional capacity is not provided.

Q3.3: How do you see the trade-offs between and within the interests of customers, funders and society? How do you see the trade-offs between current and future customers, funders and society?

McNulty is clear on the need to reduce the costs of operating the UK rail network. Recent experience on ECML demonstrates that existing industry processes obstruct the growth of new profitable rail services. Continued taxpayer support requires that the taxpayer benefits from the operation of rail services, either directly or indirectly. In order to reduce the requirement on the UK taxpayer we recommend that new, generative services, passenger and freight, with positive business cases should be encouraged as these benefit customers, funders and society.

Q3.4: To what extent do you think we should measure and monitor the delivery of those outcomes and outputs we incentivise? What metrics should we use? To what extent is it practical and desirable to monitor delivery of outcomes at the local level?

From a passenger perspective, we suggest total passenger revenue, a growth metric, and NPS metrics.

Q3.5: What do you see as the key enablers for Network Rail's successful delivery of outcomes in CP5? How should we best measure Network Rail's performance against these enablers? How should we best incentivise these?

Transparent and effective regulation, a clear understanding of customers' needs, adequate funding and the continuation of the existing output measures. In addition we propose customers take an active part in Network Rail management, including TOC and FOC representation on the Network Rail Board.

Q3.6: What do you see as the key features of the transmission mechanism? How do Network Rail's customers respond to changes in Network Rail's behaviour and how does this translate into the experience of end-customers and society? How should we take this into account in the design and implementation of our incentives?

We consider that the Management Incentive Plan should reflect the financial success of their customers, together with the financial and reputational impact of non delivery.

Q3.7: How do you think industry reform would affect the transmission mechanism? How do you think changes to franchise agreements would affect the transmission mechanism?

We recognise that Network Rail employs some excellent people who are customer focussed. However in our experience this is generally as a result of personal pride and loyalty to the rail product rather than through the "transmission mechanism". It is often evident that some key Network Rail staff are unaware of the passenger and financial impacts of their decisions.

This can be addressed through alliances. However when ownership and management of TOC and infrastructure remains separate, we again recommend a transparent Management Incentive Plan which reflects the financial success and NPS scores of Network Rail's customers, together with the financial and reputational impact on customers of non delivery.

Q4.1: What are your views on our proposed principles for efficiency sharing arrangements between Network Rail and train operators? To what extent to do you think they will improve the incentives on train operators to work with Network Rail to reduce its costs?

Whilst we understand why this is being proposed, we are not convinced that it is an appropriate method of incentivising Network Rail. Our principal concern is that TOC shareholders have a much shorter time horizon and do not have expertise in Network Rail's asset management. There is therefore a risk that short termism could lead to a cost increase in the long term or degradation of the asset base. We would prefer to rely on strong, effective, independent, economic Regulation of Network Rail. We consider that incentives to reduce costs can be more effectively achieved by one organisation having the skills to challenge Network Rail than a group of competing customers.

We would also wish to understand how over or under performance would be measured. We do recognise that provided the criteria are clearly set such a mechanism could achieve useful benefits.

Q4.2: What are your views on our proposed design of a route-based efficiency sharing mechanism, as described in chapter 4 and in Annex B? To what extent to do you think they will improve the incentives on train operators to work with Network Rail to reduce its costs?

We refer to our answer to Q 4.1.

Q4.3: What are your views on our assessment of the role of bespoke arrangements? In what circumstances do you think bespoke arrangements are likely? What advantages and disadvantages might they bring? How should we best assess them? What are your views on the scope for excluding some of Network Rail's costs from the default efficiency sharing mechanism?

As UK rail is not a homogenous product it is quite reasonable to consider bespoke arrangements.

GNER had a bespoke Schedule 4 and 8 in CP1. The bespoke Schedule 8 was simple to understand driven by attributed minutes delay and was universally briefed to operational staff. It facilitated greater focus on performance than the template regime through requiring attribution of delay at 2 minutes and above. It also included an incentive on Railtrack to deliver specific trains to destination on time consistently. In the view of GNER and Railtrack, the simplicity and daily calculation of the regime enabled business cases for investment in performance.

In comparison, the template regime is not well understood and is merely a scoring mechanism. The failure of the regime is illustrated through East Coast's performance still being lower than that which British Rail achieved. We consider the complexity of the regime is why Network Rail has not apparently recognised the level of capital investment that could be funded by Schedule 8.

We therefore consider that there is scope for introducing bespoke arrangements if they are supported in concept by ORR. To achieve this, the regime needs to be simple to avoid transactional costs in setting up and operating the regime, support from the DfT (due to application of Schedule 9 and or Clause 18.1) and they must be agreed before the commencement of the Control Period.

Q4:4 What are your views on our assessment of potential impacts of a route-based efficiency sharing mechanism, as described in chapter 4 and in Annex B?

See answer to Q 4.1.

Q4.5: What are your views on our preliminary proposal for exposing passenger and freight operators to changes in Network Rail's fixed costs in subsequent periodic reviews?

East Coast's fixed charge has varied between c£40m and c£160m per annum. The changes have been driven by changes in HMG and ORR policy and also a substantial increase in the RAB following Hatfield. It is clearly inappropriate for TOC's to bear the burden of changes to fixed charges of this volume.

Train operators by their construct are unlikely to be able to absorb major shocks through changes in the size of the RAB or the cost of capital.

In the event that the fixed charge was reduced in a subsequent periodic review, unless such a change was captured through the Franchise Change mechanism the benefit would be to TOC shareholders rather than customers and funders.

Q5.1: Do you think that the current possessions and performance regime broadly help to align incentives between operators and Network Rail in the best interest of customers, funders and society? If not, why not?

To the extent that the possessions regime encourages timely planning and the performance regime generally encourages performance they do align incentives. However the complexity of Schedule 8 blunts its effectiveness in driving investment.

Q5.2: Do you think it is appropriate to retain Schedules 4 and 8 as liquidated sums compensation regimes?

Yes. On a route such as ECML, poor performance and poorly planned possessions have a large impact on revenue. A franchisee that has competed for a rate of return needs protection from these risks.

However as Network Rail's impact on a TOC's success is broader than possession planning and performance, an alternative approach could be to replace Schedules 4 and 8 with a revenue sharing mechanism.(see also answer to Q 5.4)

Q5.3 Do you think it would benefit customers, funders and society and encourage greater co-operation if Schedule 8 compensation rates from Network Rail to train operators did not reflect the full impact of possessions on revenue and costs? We also welcome any further views on this issue in relation to Schedule 4.

Absolutely not. From an East Coast perspective where over 90% of revenue is discretionary and there is active competition from other modes, the monopolistic supplier needs to be incentivised to improve performance and possession management by feeling the full financial impact of their decisions. We refute the concept that the full compensation regime results in us not mitigating the impact. East Coast will always seek to maximise revenue and passenger satisfaction and the money received through Schedules 4 and 8 do not prevent this.

Q5.4: Do you think existing incentives are as effective as they can be in ensuring that Network Rail and train operators perform at a level that is economically and socially optimal, and whether they sufficiently drive Network Rail behaviour? In particular, we invite views on whether we should place further incentives on Network Rail to ensure it fully takes into consideration the impact of service disruption on passengers, i.e. disruption above that already reflected in Schedules 4 and 8 compensation payments for loss of fare revenue, and how we could go about doing this.

The existing regimes are complex and mechanistic. We consider that the real need for Schedules 4 and 8 is to protect the TOC from loss of revenue due to loss of customer satisfaction from poor performance/possession management and share the benefits with Network Rail for above benchmark performance. However the complexity of the regimes can lead to perverse outcomes, e.g. less disruptive solutions generating greater S4 payments.

A more effective and cheaper solution would be to incentivise Network Rail according to changes in TOC revenue.

Q5.5: Do you envisage any barriers to modifying or replacing the Schedule 4 and 8 regimes in cases where both a train operator and Network Rail wish to? What do you see as the advantages and disadvantages of bespoke approaches? Do you agree with our proposal regarding the circumstances when we will approve bespoke Schedule 4 and 8 arrangements?

Previous experience indicates that a numeric regime requires significant input in calibration and legal preparation. Other than agreement of TOC/Network Rail, approval by ORR will be required and also DfT for a franchised operator. The main barriers are time and cost.

There may also be a requirement for commercial indemnities against unintended consequences during the transition phase.

Q6.1: In what circumstances do you think bespoke charging arrangements are likely to occur? What advantages and disadvantages could such arrangements have? How might they work for or against the alignment of incentives?

It is most likely to occur where a TOC wishes to purchase additional outputs from Network Rail in terms of performance and/or possession management. As they will require significant investment of management and legal time, they will only succeed if they align incentives. A revenue sharing mechanism would be simpler to implement and provided passenger revenue is a good proxy for passenger benefit then again it is unlikely that such a regime would not align incentives. Such a regime, which would require approval by ORR would need to be linked to delivery of outputs and recognise other factors that drive revenue.

Q6.2: What protection do you think might be needed for third parties not included in the scope of a bespoke arrangement?

The normal process of industry consultation following an application being submitted to ORR under S17/18 or 22. In addition a bespoke regime can be terminated by ORR at the implementation of the next Control period.

Q6.3 Do you agree that it would be helpful for us to set out a set of principles on the basis of which we would decide whether to approve bespoke arrangements? Do you have any views on what those principles should be?

Absolutely. This is essential to give TOC's and Network Rail a framework leading to a regime which has a reasonable prospective of Regulatory approval.

Q6.4 How do you think we should treat bespoke charging arrangements that might span Network Rail control periods or change within control periods?

The revenue streams would be included in the calculation of Network Rail's funding requirement. Alternatively ORR could use the Periodic Review process to terminate the bespoke regime.

Q7.1: What are your views, additional to those set out in your response to our May consultation, on our treatment of the following options:

(a) The scope of our proposed review of the volume incentive, including disaggregation by Network Rail route and consideration of a down side as well as an upside?

In relation to East Coast Main Line we are not aware of any instance where the volume incentive has been effective.

(b) That we continue to support the rationale for the capacity charge, and will support Network Rail in its work to revisit and recalibrate the charge for PR13?

Again in relation to East Coast Main Line we are not aware of any instance where the capacity charge has incentivised Network Rail to sell additional paths. We are not convinced that there is a formulaic relationship between an increased number of trains on the network and train performance. A timetable restructuring can create capacity which can then be used in a more efficient manner than previously.

(c) That we should establish the extent to which infrastructure capacity is under-utilised before proceeding to develop one or more indicator by which to monitor capacity utilisation?

Yes. However considering the experience of the East Coast Main Line since 2005 we have considerable reservations as to Network Rail's ability to identify spare capacity.

Q7.2: What are your views, additional to those already expressed in your response to our May consultation, on the policy we are considering further to levy a charge to incentivise better use of capacity?

None.

Q8.1: Do you agree with the criteria that we have applied in assessing different options to Network Rail's cost of capital and our approach to its financial structure?

East Coast does not feel able to answer this question.

Q8.2 Do you agree that we should use a cost of capital for Network Rail that reflects the risks faced by the business, even though this may not reflect the company's actual financing costs?

No, by doing this the regulatory regime would be divorced from the reality that Network Rail is facing and this may lead to inappropriate decision making.

Q8.3: How do you think we should deal with the surplus cash that results from such an approach?

By re-investing in the railway to the benefit of customers.

Q8.4: What advantages and disadvantages do you see in our regulating Network Rail in a way that preserves the options for changes to the company's financial structure?

In order to actively regulate Network Rail, ORR needs access to as wide a range of options as possible.

Q8.5: How should we strike the right balance between the interests of current customers and funders and future customers and funders?

By listening to customer requirements. Specifically through having TOC/FOC, passenger and freight customers involved in the regulation and governance of Network Rail.

Q9.1: How do the incentive properties of our different treatments of different classes of expenditure affect operating decisions on the ground, e.g. is it the potential financial gain or loss that motivates actions or is are decisions more based on other factors such as relative complexity, cultural factors (e.g. tradition or professionalism) or the nature of Network Rail's financing and governance arrangements?

East Coast does not feel able to comment on this.

Q9.2: Are the incentives on Network Rail affected by the different ways we may assess support, operations and maintenance costs, compared to renewals and enhancements expenditure? In particular, we may use a base year for support costs that is rolled forward by an efficiency assumption, whereas for renewals we will probably not roll forward a base year but will take a view on the likely level of expenditure in each year on a pre-efficient basis and then apply an efficiency assumption.

East Coast does not feel able to comment on this.

Q9.3: Do you expect Network Rail's work on whole-life costs to change its decision-making, and in what way?

East Coast does not feel able to comment on this.

Q9.4: Is there any evidence of 'capex bias' at Network Rail? To what extent is this undesirable?

East Coast is not aware of any.

Q9.5: Should we seek to equalise the incentives for different types of income and expenditure? How best might we do this?

No, incentives must be appropriate to the nature of the income or expenditure in question.

Q10.1: Do you agree with our overall proposed approach to incentivising innovation? If not, what do you propose we do instead?

See answer to Q 10.2

Q10.2: What merit do you think there would be an innovation fund? How should such a fund work? How would we guard against 'crowding out' and ensure the fund did not displace existing expenditure?

We welcome this, but innovation must be targeted at resolving the issues faced by the network and customers of Network Rail.

Q10.3: What merit do you think there would be in an innovation prize? How should such a prize work? Who should be eligible to enter? What sort of prize would best stimulate genuine innovation?

East Coast does not feel able to comment on this.

Q10.4: In relation to the use of output KPIs, what KPIs do you think we should target and why? Should we monitor them only or should they have some incentive attached to them and if so what?

KPI's should be simple, readily understood and appropriate to customer requirements. Incentives should be linked to achievement of KPI targets.

Q10.5: Do you think that KPIs should be introduced for companies other than Network Rail to monitor innovation across the wider industry?

Franchised TOC's are constrained by franchise agreements. The KPI's could be contained in that agreement.

Q10.6 Beyond any comments that you may have made to us in response to our May consultation, do you have any comments on our overall approach to environmental incentives? Specifically, do you think we should introduce other environmental incentives beyond those that we are proposing? Do you think we should go further in encouraging the rail industry to improve its environmental performance even if this resulted in a shift to other modes?

We struggle to comprehend how a shift from rail to car or air would benefit the environment or be congruent with ORR's statutory objectives.

Q10. 7 We are keen for the industry to propose methodologies for monitoring emissions and producing improved whole-life, whole-industry business cases. What role do you think the ORR should play in this process?

We suggest that ORR considers accurate metering and fuel monitoring becoming a Licence Commitment.