8th February 2012

Mr Richard Owen
Office of Rail Regulation
One Kemble Street
London
WC2B 4AN

Dear Mr Owen,

Re: Periodic Review 2013: Consultation on Incentives

Thank you for the opportunity to comment; this document is the response to your December 2011 consultation document. I confirm that no part of this response is confidential.

Before commenting on the specific consultation questions we would like to make some general points about the context in which the periodic review is taking place and some of the concerns your consultation document raises for us.

We believe that incentives play a key role in ensuring that the industry responds to the needs of its customers efficiently and effectively. It is important, therefore, that both the structure and level of incentives are set in such a way as to ensure an appropriate response; this is particularly the case with an organisation with an unusual corporate structure, such as Network Rail.

As might be expected in the background provided by the McNulty report the document emphasises an approach which considers industry outcomes as the basis for assessing whether incentives are appropriate; however this appears to be at the expense of a consideration of the impact of the incentives on Network Rail's efficiency.

The McNulty report takes Network Rail's achievement of a degree of efficiency over the course of CP5 as a given, it also proposes that the industry could deliver, in the high case scenario, a further billion of efficiencies by 2019; in this scenario the vast majority of efficiencies are delivered by Network Rail. Industry efficiency is instrumental to the delivery of a key outcome: value for money. Whether this translates to benefits for fare-payers (and thus an increase in passenger satisfaction), or taxpayers, is a policy decision for the DfT; however there is insufficient consideration of the incentive for efficiency in your document.

Network Rail's corporate structure presents unique challenges and risks for the creation of an incentive regime. Standard economic or commercial incentives may have less impact than the structure of its management incentive plan or the perceived reputational impact of a course of action. Setting a context where success is measured by whole industry outcomes leads to the risk that Network Rail will try to dictate outcomes, rather than act as an effective supplier to enable its customers to deliver them, it also risks distracting management effort from improving its supply chain.

The test of an effective incentive is the value derived from it, i.e. does the efficiency derived from the incentive outweigh the cost of the incentive itself. This needs to be given particular consideration to the development of proposals to align TOC and Network Rail incentives and of Network Rail's cost of capital and the extent to which unsupported debt is used.

There seems no immediate reason for train operators to share in any of Network Rail's efficiency downside, this seems to us contrary to the principle that risk should be borne by the person best placed to manage it. TOCs have no ability to manage, for example, Network Rail's supply chain costs; however there are areas where train operators can contribute to Network Rail improving its efficiency. Introducing a new risk will increase the level of reward sought by franchisees, a risk that cannot be managed will increase reward sought significantly and raise the cost of franchising and we question the value for money of this.

Whilst Network Rail's cost of capital has little direct impact on train operators it has a significant impact on whole industry value for money and sustainability; under the two scenarios presented in the consultation document that question is treated as a matter of timing, i.e. a high cost of capital allows Network Rail to make bullet payments and reduce its debt; whereas with a low cost of capital debt simply mounts, ultimately the cost of debt and thus funding requirement remains the same. The high cost of capital scenario effectively converts debt/RAB funding into "pay as you go", surely there is a third scenario which assumes a low cost of capital and a proportion of "pay as you go" renewal and enhancement schemes?

The issue of unsupported debt needs to be tested against two criteria; value for money and the impact on Network Rail as a supplier. The former is an, in principle, straightforward test of whether the commercial incentives created by having creditors who are at risk drives greater efficiency than not. The latter is a judgement on how those commercial pressures will translate into behaviours; it will do very little for industry alignment if the increased commercial pressure on Network Rail reduces its responsiveness to its customers in favour of its creditors.

Our responses to your specific questions are attached to this letter.

Yours sincerely

Alex Hynes
Managing Director – Rail Development

Enc: Appendix