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Your ref:

Our ref:
NRS11-110

Date: 8 February
2012

By email
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Dear Richard

PERIODIC REVIEW 2013: CONSULTATION ON INCENTIVES

First of all, many thanks for the opportunity to respond to the PR13 consultation on incentives.

I have offered comments on the specific questions in the annex attached. However, I thought it would also be useful make some more general observations.

This consultation represents a critical juncture in both the periodic review and the shaping of the future of rail services in Scotland through our Rail 2014 consultation. It will greatly influence many of the key decisions taken in respect of Network Rail's financial framework for Control Period 5 and potentially beyond, and will form part of our considerations as we look towards the next contract for passengers services in Scotland. Therefore it is vitally important that that the ORR is able to deliver a regulatory incentives regime:

- which helps deliver a lower cost railway that provides greater value for money for passengers, freight customers and taxpayers in Scotland;
- which drives Network Rail towards maximum efficiency;
- which encourages Network Rail to promote and deliver outcomes aligned with the strategic objectives of the Scottish Government;
- which strikes the right balance of risk between Network Rail and the funder of rail services;
- which recognises the criticality of ensuring that rail remains resilient even in the most challenging of circumstances; and
- which recognises that the Scottish Government is the principal funder of Network Rail in Scotland and the nature of large parts of the Scottish rail network as a social rather than commercially self-funding railway.

In terms of resources, we are now witnessing the beginning of a period of sustained consolidation in public spending. For the Scottish Government this has meant that significantly less Capital DEL funding is being made available from the UK Government for capital investment and, under the current constitutional framework, these funding constraints are likely to continue into future Spending Review rounds relevant to Control Period 5.

In terms of railway investment, the Initial Industry Plan (IIP) made clear that many rail services in Scotland are provided for socio-economic rather than commercial reasons and are consciously subsidised. In contrast to much of the rail network in England and Wales, Scotland's railways are, under current arrangements, unlikely to be subsidy free over the short to medium term. This has important implications for our position with respect to Network Rail's financing arrangements and their overall level of indebtedness. The Scottish Ministers have made clear their intention to continue to invest in Scotland's rail infrastructure within a sustainable financial framework. The financing arrangements for Control Period 5 and beyond should reflect this.

The Scottish Government Programme for Scotland (¹) reflected that the delivery of public services must be based on outcomes that matter to the people of Scotland, rather than be dictated by professional silos and organisation boundaries. The Programme also made clear that locally integrated, seamless provision was the most effective way to deliver high quality public services and represented the most effective use of public resources.

Our Rail 2014 consultation (²) is seeking views on the future shape of Scotland's railways. As part of this Scottish Ministers have expressed a very clear view that greater integration in the delivery of rail services will improve the efficiency, the quality and the resilience of those services. Ministers have looked towards the industry on how best to deliver this, and significant work is underway with the decentralisation of Network Rail and the development of its Alliance Agreement with First ScotRail. We have a very clear expectation that the regulatory incentives that are put in place in Control Period 5 will build upon this early work and facilitate its early evolution. We would also expect that the incentives are tailored to the specific needs of the network in Scotland, and contain sufficient flexibility to enable collaborative working between Network Rail and train operators to develop and evolve.

Scotland's railways has undoubtedly been a success in recent years and one of the underpinning principles of our Rail 2014 consultation is to build on that success. This same principle should also read across to the ORR's approach to PR13. In considering the right incentives regime for Control Period 5, significant thought and analysis must be given to the experience in Control Period 4, the success or otherwise of the provisions currently in place and the evolving industry structures. Simplicity and ease of understanding should also be a key aim: as indicated previously, the periodic review represents an opportunity sweep away the unnecessary or ineffective and to simplify the overly complex.

Our engagement during PR13 has been very positive to date, and we look forward to working closely with you as you develop your conclusions on incentives and funding arrangements for Control Period 5.

Yours sincerely



Steven McMahon
Head of Rail Strategy

¹ 'Renewing Scotland: The Government's Programme for Scotland 2011-2012', Scottish Government, September 2011.

² 'Rail 2014 – Public Consultation', Transport Scotland, November 2011.

Question no.	Question	Comments
Part 3 – understanding the PR13 objective		
3.1	Do you agree that in PR13 we should focus on incentivising delivery of outcomes that customers, wider society and funders value?	<p>We are broadly supportive of an outcome based approach to the Periodic Review, which chimes with the approach taken by Scottish Government, as outlined in the recently refreshed Government Economic Strategy (GES) ⁽³⁾.</p> <p>However, we do recognise the importance of setting and monitoring more detailed targets towards the delivery of the outcomes.</p>
3.2	Do you agree with our assessment of the outcomes that customers and society value?	<p>Our response to the ORR's consultation on objectives outlined our view that passengers and freight customers should be at the heart of the periodic review. This aligns with our approach in the Rail 2014 consultation.</p> <p>The Scottish Government's purpose, as outlined in the GES, is sustainable economic growth for the benefit of all of Scotland. In support of this, Scotland's Railways includes improving journey times and connectivity as a strategic outcome. We would therefore expect that these will be key considerations in the ORR's approach to the periodic review.</p> <p>The Scottish Government's Climate Change (Scotland) Act 2009 ⁽⁴⁾ contains world leading targets for reducing carbon emissions, and we would expect that rail in Scotland will contribute to these.</p>

³ 'The Government Economic Strategy', the Scottish Government, September 2011.

⁴ 'Climate Change (Scotland) Act 2009', 2009 asp 12.

<p>3.3</p>	<p>How do you see the trade-offs between and within the interests of customers, funders and society?</p> <p>How do you see the trade-offs between current and future customers, funders and society?</p>	<p>Rail users, funders and society more generally will all benefit from rail services which are leading edge efficient, which provide a high quality of product and which are resilient in even the most challenging of circumstances. The outcomes of this periodic review must support this.</p> <p>A key function of the ORR is to ensure a balance between the long term sustainability of the railway and the short term cost pressures in the current fiscal climate. In doing so, the ORR must ensure that they deliver an outcome which is affordable, and which represents best value for money for passengers, freight users and the taxpayer. Passenger, freight users and funders all share from the benefits of a more efficient railway.</p>
<p>3.4</p>	<p>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?</p> <p>To what extent is it practical and desirable to monitor delivery of outcomes at the local level?</p>	<p>It is critical that the ORR is able to both measure and predict NR's performance against the regulatory outcomes. Amongst other things, this is necessary to safeguard public investment in rail services.</p> <p>Monitoring should be undertaken at a route based level, with metrics that are meaningful and drive the right behaviours but which do not entail unnecessary administrative burdens.</p> <p>Reporting on performance in the widest sense should be tailored where appropriate to the needs of the funder, and it is important that the ways in which the ORR communicates on these issues is transparent and easy to understand.</p> <p>We are currently considering our approach to specifying outputs in the HLOS, and this will be informed by the outcomes of Rail 2014 consultation and the ORR's Advice to Ministers.</p>

3.5	<p>What do you see as the key enablers for Network Rail's successful delivery of outcomes in CP5?</p> <p>How should we best measure Network Rail's performance against these enablers?</p> <p>How should we best incentivise these?</p>	<p>We are broadly supportive of the enablers identified in the consultation document, though would reflect that a substantial improvement in NR's asset knowledge and transparency of asset data for all system users will be required before excellence in asset management can truly be achieved.</p> <p>In order to achieve real efficiency through decentralisation, NR should have the ability to develop policies and strategies which fully reflect localised needs and circumstances. The ORR may wish to reflect this as a key enabler.</p> <p>It is also critical that we use PR13 to create an environment which encourages and values innovation. The ORR may wish to consider this as a key enabler.</p> <p>The sign that the enablers are working is an efficient, effective, rail system which delivers a high quality, value for money product for users. The contribution that rail makes to the strategic objectives of the Scottish Government should also be clearly demonstrable.</p> <p>Clear and well understood regulatory metrics which are underpinned by the principles outlined above. There should also be an explicit and transparent link between the successful delivery of the regulatory metrics and the NR Management Incentive Plan, and this link must be effective enough to limit or, in the case of aspects of performance failure, prevent excessive and disproportionate bonuses.</p> <p>Along with the general approach to PR13, we would also suggest that the ORR may wish to revise its enforcement policies for Control Period 5 to ensure that</p>

		they achieve a positive outcome for passengers and freight users.
3.6	<p>What do you see as the key features of the transmission mechanism?</p> <p>How do NR's customers respond to changes in NR's behaviour and how does this translate into the experience of end-customers and society?</p> <p>How should we take this into account in the design and implementation of our incentives?</p>	<p>That an ethos of high performance against all objectives, efficiency, responsiveness and innovation for the benefit of rail users and funders pervades all aspects of NR's operations at all levels within the organisation.</p> <p>There is willingness across the industry to work in close collaboration for the benefit of passengers and freight users, and NR must embrace this in its approach to dealing with its customers.</p> <p>Rail users rightly expect a high level of service from Scotland's railways: the ORR must ensure that NR fulfils its role by ensuring a safe, efficient and resilient network.</p>
3.7	<p>How do you think industry reform would affect the transmission mechanism?</p> <p>How do you think changes to franchise agreements would affect the transmission mechanism?</p>	<p>The ethos which underpins rail reform is working better together for the benefits of passengers and freight users. The transmission mechanisms must support and encourage industry reform.</p> <p>We have still to conclude on our Rail 2014 consultation, which will help shape the next franchise for rail passenger services in Scotland. However, we would expect that as a minimum the franchise agreement will strengthen collaborative working.</p>
Part 4 – Aligning NR and train operators' incentives to increase efficiency		
4.1	What are your views on our proposed principles for efficiency sharing arrangements between NR and train operators?	We are broadly supportive of measures which support a move towards an integrated approach to the delivery of rail services.

On a route-based efficiency benefit sharing mechanism specifically, as indicated in the consultation document we would require further, more detailed analysis on the effects of such a mechanism in place on the Scottish operating route. In this respect, we are engaged with the ORR on the development work by KPMG, and will expect detailed analysis to be included in the ORR's Advice to Ministers. We will also consider the outcomes of the Rail 2014 consultation before finalising our formal position.

In the meantime, I would offer the following general comments on REBS:

- There is as yet no clear link between REBS and the benefits to rail users and funders through lower revenue requirements.
- As NR improves its efficiency, the scope for benefits decreases, while TOC exposure to downside risk will increase. This therefore brings into question the sustainability of REBS, and it may be that as an incentive it would only be truly effective for 2 or 3 Control Periods.
- Consideration of the scope for overall NR efficiency should be separated completely from the considerations on REBS. We would not support an artificial lowering of regulatory efficiency targets in order to make REBS more attractive/easier to implement.
- Concentration on cost efficiency risks a focus which works against revenue generation, and we would wish to explore further incentive sharing regimes which consider revenue as well as cost with the objective of reducing net operating cost after revenue.

	To what extent do you think they will improve the incentives on train operators to work with NR to reduce its costs?	This is a question which must be answered by the ORR. In particular, the time scales and likely impact on NR Scotland's revenue requirements and overall Scottish rail industry funding requirements.
4.2	<p>What are your views on our proposed design of a route-based efficiency sharing mechanism, as described in chapter 4 and Annex B?</p> <p>To what extent do you think they will improve the incentives on train operators to work with NR to reduce its costs?</p>	<p>As outlined above, there is a question as to the sustainability of the model. However, it may be effective as an initial enabler which facilitates future bespoke agreements. This will, however, need to be demonstrated.</p> <p>This is currently unclear, and requires further detailed analysis from the ORR.</p>
4.3	<p>What are your views on our assessment of bespoke arrangements?</p> <p>In what circumstances do you think bespoke arrangements are likely?</p> <p>What advantages and disadvantages might they bring?</p>	<p>Bespoke arrangements are likely to be more sustainable in the longer term than the default arrangements described in the consultation document. They will also better reflect local dynamics and also the differing approaches of the train operators. The ORR should ensure that the regulatory framework is sufficiently flexible to accommodate bespoke arrangements, particularly in the context of recent Alliance Agreements across the network.</p> <p>We are currently developing our position on the future of rail services in Scotland post 2014, which will be shaped by the Rail 2014 consultation. It may be the case that that bespoke arrangements will help to facilitate the delivery of policy aspirations, particularly around a more integrated approach to the delivery of rail services in Scotland.</p> <p>Bespoke arrangements will be tailored to recognise</p>

	<p>How should we best assess then?</p> <p>What are your views on the scope for excluding some of Network Rail's costs from the default efficiency sharing mechanism?</p>	<p>local needs and can facilitate the delivery of very specific aspirations. Where the agreement involved a dominant TOC, the position of freight and minor passenger operators will need to be safeguarded through the regulatory framework.</p> <p>We will await the more detailed analysis before taking a view on this.</p>
4.4	<p>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?</p>	<p>For the assessment to be really meaningful and useful, it has to be done at a route level. It also failed to clearly demonstrate the effects on NR's revenue requirements, which is the key issue for funders.</p> <p>Annex B was at points fairly complex. The ORR seeks simplicity from the industry, and this analysis may suggest that the mechanism may be too complex to achieve the desired outcomes.</p>
4.5	<p>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?</p>	<p>The assessment of this within the consultation appeared to be based on system of longer, more loosely specified franchise agreements. As already indicated above, Scottish Ministers have still to conclude on the form and function of the franchise for Scottish passenger services post 2014.</p> <p>I would however offer the following general comments:</p> <ul style="list-style-type: none"> • The evidence base for this change is currently very limited, particularly at route level, and I am doubtful that the experience in the freight sector is a sufficiently robust basis on which to base a view on what is potentially a significant change. • Undoubtedly exposing train operators to this change will mean that they have a greater

		<p>incentive to participate in periodic review. However, the regulatory framework within which the review operates is complex, and there is therefore a question as to the ability of the train operating companies to become fully engaged without a requirement for extra resource, the cost of which would inevitably flow through to franchise costs. I would suggest that there should be sufficient expertise within the ORR to represent the interests of the train operating companies without necessarily exposing them to additional risks.</p> <ul style="list-style-type: none"> • Relative to the point made above, additional exposure to changes at periodic review will inevitably translate into increased risk premia in the franchise bids. This may be outweighed by the efficiency benefits of the change, but this has still to be demonstrated by the ORR. • Depending on franchise length, there could be circumstances where train operating companies are bidding for franchises at the same time as trying to influence the outcome of the periodic review. This has considerable resource implications for both those companies and potentially NR. In addition, it is difficult to see what benefit an outgoing franchisee will see in the effort put into influencing the outcomes of the periodic review, which may conversely give unfair advantage to an incumbent.
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Part 5 – Possessions and performance regimes

5.1	Do you think that the current possessions and performance regime broadly help to align incentives between operators and NR in the best interest of customers, funders and	Very broadly yes. However, there is relatively well known anecdotal evidence of unintended consequences and behaviours, particularly around the
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	<p>society? If not, why not?</p>	<p>Schedule 8 performance regime. If the ORR is minded to retain Schedule 4 and Schedule 8 they must look to eradicate any scope for such behaviours, fully 'road-testing' the new arrangements before they come into effect.</p> <p>While Schedule 8 may work as an incentive to maintain performance, this can create too narrow a focus, potentially at the expense of other industry wide objectives such as capacity maximisation, journey time improvements, management of connections and growth of new business.</p> <p>The creation of closer, more integrated working practices such as Alliances would present an opportunity to develop bespoke arrangements which better reflected local circumstances, were less complex, required less resources to deliver and which created a much greater shared interest in maintaining and delivering specified network capacity. We would welcome a discussion with the ORR on this issue, in particular how to ensure that the regulatory framework for Control Period 5 is sufficiently flexible to accommodate such arrangements.</p> <p>Consideration of Schedule 4 arrangements should operate hand in hand with the revision of the Network Code and the regulatory parameters within which NR operates in terms of planning possessions. The penalties for possession over-run are such that it could be argued that project teams are incentivised to book longer possessions on a precautionary basis.</p>
5.2	<p>Do you think it is appropriate to retain Schedules 4 and 8 as liquidated sums compensation regimes?</p>	<p>If the ORR is minded to retain Schedule 4 and Schedule 8 largely as currently described, then it should be on this basis. An approach based on punitive damages may be inconsistent with Scots Law. However, the ORR may wish to consider whether there</p>

		is an alternative, whole system approach through which both the TOC and NR are jointly incentivised. This would potentially create a greater focus on overall delay reduction, rather than delay attribution.
5.3	Do you think it would benefit customers, funders and society and encourage greater co-operation if schedule 8 compensations rates from NR to train operators did not reflect the full impact of possessions on revenue and costs? We would also welcome any further views on this issue in relation to Schedule 4.	Such an approach may incentivise TOCs to work with NR to manage the limitation in the use of possession. However, further evidence of the effects of this would be required. At an anecdotal level, at recent ORR events some train operators have expressed the view that the current system does not fully compensate them for the costs of possessions. While there is some anecdotal evidence of closer working, in general this does not seem to have incentivised train operating companies to work with NR to minimise disruption.
5.4	Do you think existing incentives are as effective as they can be in ensuring that NR and train operators perform at a level that is economically and socially optimal, and whether they sufficiently drive NR behaviour? In particular, we invite views on whether we should place further incentives on NR 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.	This is questionable. Given the arrangements with track access charging, NR is at worst held cost neutral in terms of compensation payments. This therefore would appear to be a fairly weak incentive in terms of influencing NR's behaviours. A system whereby NR have a strong financial incentive – based on loss rather than benefit - to minimise disruption may be of greater effect, particularly where it is clearly and explicitly linked to the Management Incentive Plan,
5.5	Do you envisage any barriers to modifying or replacing the Schedule 4 and 8 regimes in cases where both a train operator and NR wish to?	Possessions and performance regimes intuitively lend themselves well to bespoke arrangements, for example within the context of an alliance agreement. In particular where there is a set of financial arrangements based on mutual reliance. It will be necessary to consider the impact on the “star” model of performance payments to other operators.

	<p>What do you see as the advantages and disadvantages of bespoke approaches?</p> <p>Do you agree with our proposal regarding the circumstances when we will approve bespoke Schedule 4 and 8 arrangements?</p>	<p>As with bespoke arrangements generally, they are tailored to the specific needs of the route in question, which should offer considerable advantage. In Scotland, there is the particular advantage that this would allow performance regimes better to reflect distinctive Scottish priorities and conditions. The interests of other users will need to be considered carefully, but this should not prevent the benefits of bespoke arrangements being secured.</p> <p>The ORR should ensure that the regulatory framework is sufficiently flexible to accommodate such arrangements.</p>
Part 6 – Access charges		
6.1	<p>In what circumstances do you think bespoke charging arrangements are likely to occur?</p> <p>What advantages and disadvantages could such arrangements have?</p> <p>How might they work for or against the alignment of incentives?</p>	<p>The consultation document captures a useful set of circumstances, in particular alliance arrangements. Such arrangements could compliment the route based approach to managing the network, setting charges at a level which better reflects the actual costs of the network in a particular location. It could also support increased efficiency through comparative regulation and collaboration and may realise capacity benefits. There would be potential for resource/cost implications as transaction activity will necessarily increase.</p>
6.2	<p>What protection do you think might be needed for third parties not included in the scope of a bespoke arrangement?</p>	<p>The ORR would need to ensure that the bespoke arrangements were transparent and consistent, but proportionate so as not to prevent or unduly limit the benefits of bespoke arrangements.</p>
6.3	<p>Do you agree that it would be helpful for us to set out a set of</p>	<p>A set of principles outlined by the ORR would enable</p>

	<p>principles on the basis of which we would decide whether to approve bespoke arrangements?</p> <p>Do you have any views on what those principles should be?</p>	<p>consistency of approach. Consideration should also be given as to whether the ORR would be required to approve any bespoke arrangements, either at systemic or actual levels.</p> <p>They should be consistent with the current principles for charging, perhaps enhanced though a requirement to clearly demonstrate that they deliver added value at local level. In the Scottish context the principles should not be inconsistent with the priorities of the Scottish Government, as the rail system's principal funder.</p>
6.4	<p>How do you think we should treat bespoke charging arrangements that might span NR control periods or change within control periods?</p>	<p>It is entirely appropriate that bespoke arrangements may span Control Periods, and in fact may provide a contribution to the evidence base for periodic review e.g. comparability.</p> <p>The ORR may wish to consider a default arrangement whereby longer term bespoke arrangements can switch to the regulatory arrangements should it be of greater benefit in terms of reducing costs etc.</p>
Part 7 – Capacity utilisation incentives		
7.1	<p>What are your views, additional to those set out in your response to our May consultation, on our treatment of the following options;</p> <p>(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?</p>	<p>At a broad level, capacity utilisation is an area where a whole industry approach will produce the optimum outcome.</p> <p>In developing its approach, the ORR should be mindful that different models of franchise agreement may be in operation. For example, there may be circumstances where specification is driven primarily by social imperatives, and therefore may be specified in greater detail. In such circumstances, the notion of responding to the market is not an issue as none really exists.</p> <p>Any work on capacity utilisation should work hand in hand with the review of the currently regulatory</p>

	<p>(b) That we continue to support the rationale for the capacity charge, and will support NR in its work to revisit and recalibrate the charge for PR13?</p> <p>(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?</p>	<p>frameworks and incentives, in particular approaches to timetabling and performance incentives.</p> <p>There is limited evidence available which would suggest that the volume incentive in CP4 encourages Network Rail to accept more trains onto the network in Scotland, and in fact performance remodelling can have the same effect in terms of triggering the incentive. However, at an in-principle level, if the ORR can justify and is minded to retain the incentive, a route-based approach would be consistent with the general approach to the periodic review.</p> <p>Also at a theoretical level a downside and upside approach would place a much stronger incentive on NR, particularly where this is directly linked to the Management Incentive Plan.</p> <p>Linked to the comments above on Schedule 8, there is a fundamental question as to the effects of an incentive which as a minimum holds NR cost neutral.</p> <p>This would be a base requirement, and should be undertaken at a route level. It will be important that this assessment is properly independent and expertly informed with reference to international best practice. There may be significant perverse incentives at work to demonstrate low existing capacity during the development of these assessments.</p>
7.2	<p>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?</p>	<p>Further discussion on this will be required once the ORR has undertaken the additional analysis. However, at a theoretical level it is questionable how effective this would be in circumstances where you have a fairly self contained network with one dominant TOC. In such</p>

		circumstances the economic value of particular routes is at best notional: the reality of competition is either non-existent or very limited. The charge would therefore risk increasing the costs of franchised services in locations where the primary driver for providing those services is social.
Part 8 – NR’s financing arrangements		
8.1	Do you agree with the criteria that we have applied in assessing different options to NR’s cost of capital and our approach to its financial structure?	Broadly yes. However, the variability of effect in different part of network should also be a factor. This is particularly the case for Scotland where executive devolution means that Scotland’s railways operate within a different policy environment to the other parts of the GB network.
8.2	Do you agree that we should use a cost of capital for NR that reflects the risks faced by the business, even though this may not reflect the company’s actual financing costs?	As the ORR financial modelling for the Scottish operating route is still in development, we are not in a position to take a formal view on this. In principle level, we expect that the ORR will take the approach that represents best value for money for rail users and funders and which strikes a proper balance between short term pressures on public finances and long term sustainability. The financing arrangements should also strike the right balance of risk between Network Rail and the funder of rail services, recognising the current fiscal environment. The approach taken should also serve to encourage innovation and greater efficiency. The ORR should also be open to the possibility of a set of financing arrangements in Scotland which may differ from the rest of the GB network.
8.3	How do you think we should deal with the surplus cash that results from such an approach?	The option which represents best value may vary across the lifetime of a Control Period. Therefore the

		treatment of a surplus should be subject to negotiation with funders at the point that it is identified. There is a difference between un-used risk provision, and genuinely delivered efficiency saving.
8.4	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?	<p>The industry is in a period of reform, and flexibility is needed to accommodate change and innovation, particularly as we move towards a more disaggregated network.</p> <p>This has to be balanced against giving NR and funders as much certainty as possible on costs over the life of the Control Period.</p> <p>Given the importance of NR debt cost to funders, flexibility should not be bought at the expense of higher finance rates.</p>
8.5	How should we strike the right balance between the interests of current customers and future customers and funders?	<p>In December last year, Scottish Ministers set out their plans for infrastructure investment in Scotland⁵. Within this, they made clear that decisions on the final balance of funding used will be based upon a sustainable financial framework. This is to ensure that we use revenue funded mechanisms, such as RAB funding, at a sustainable level and do not overly constrain our choices for future years.</p> <p>We would welcome a discussion with the ORR on how best to develop funding arrangements for the Scottish operating route for Control Period 5 which are underpinned by the above.</p>
Part 9 – The incentive properties of opex and capex cost recovery		
9.1	How do the incentive properties of our different treatments of	We will not be in a position to offer a formal views on

⁵ 'Infrastructure Investment Plan 2011', the Scottish Government, December 2011.

	different classes of expenditure affect operating decisions on the ground, e.g. is it the potential financial gain or loss that motivates actions or are decisions more based on other factors such as relative complexity, cultural factors (e.g. tradition or professionalism) or the nature of NR's financing and governance arrangements?	<p>this until we receive the options analysis which I understand will be included in the ORR's advice to Ministers.</p> <p>At an in-principle level the ORR should focus on the achieving the greatest value for money for passengers, freight and the taxpayer.</p> <p>The ORR should also revisit the balance of risk. In particular, whether a 25%:75% risk ratio for capex is still appropriate in the current economic climate. The ORR needs to be mindful of the signals which this ratio sends to NR, particularly if a different approach to risk improves efficiency.</p>
9.2	Are the incentives on NR 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.	As funders, we would rely on the ORR to create the framework which ensures that NR is operating at maximum levels of efficiency. In this context, the ORR should adopt the approach which drives the most efficient behaviours, particularly in the context of long term sustainability whilst having regard to affordability constraints in the short run. This may result in one corporate level approach or a range of approaches across routes, sectors or functions.
9.3	Do you expect NR's work on whole life costs to change its decision making, and in what way?	In theory, a whole life costs approach is most efficient, but we would need to see the detail of NR's work before taking a view on this. It would be helpful to see evidence of where whole life costing decisions in CP4 are contributing to genuine cost reductions in CP5.
9.4	Is there any evidence of "capex bias" at NR? To what extent is this undesirable?	Please see answer to 8.5 above. We would rely on the ORR if necessary to enforce the approach which represents best value.
9.5	Should we seek to equalise the incentives for different types	See answer to 9.2 above.

	of income and expenditure? How best might we do this?	
Part 10 – Other incentives		
10.1	Do you agree with our overall proposed approach to incentivising innovation? If not what do you propose we do instead?	Broadly yes, and this would allow the workstreams such as RDG to have real influence in NR’s approach to its operations. However, the ORR needs to ensure that efficiencies are being derived from innovation, and not through other measures, such as the deferral of work.
10.2	What merit do you think there would be in 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 have seen evidence that innovation levels in the GB rail industry fall below those in comparable rail networks or industries, and accept the premise that this has played a part in GB railways higher costs. We also note that innovation needs to be applied on a whole system basis, rather than simply as an incentive on NR. It is apparent that existing incentives and arrangements have not been sufficient to encourage effective innovation, so some change is necessary. To the extent that an innovation fund can address these failings, we would support it. We would expect to see savings from innovation begin to be delivered within CP5, and thus would expect any allocation of funds to innovation to be at least cost neutral in CP5.
10.3	What merit would there 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?	There are already a number of industry awards for innovation. These can serve to showcase ideas which deserve recognition, and therefore assist in the adoption process, which can be a more effective prize than a cash award. Perhaps the ORR might give consideration to support for these existing award processes.
10.4	In relation to the use of output KPIs, what KPI’s do you think	The effects of innovation should reflect in NR’s ability to

	we should target and why? Should we monitor them only or should they have some incentive attached to them, and if so, what?	meet and exceed challenging efficiency targets. The periodic review should seek a Determination for Control Period 5 which is simple.
10.5	Do you think that KPIs should be introduced for companies other than NR to monitor innovation across the wider industry?	See answer to 10.4 above.
10.6	<p>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?</p> <p>Specifically, do you think we should introduce other environmental incentives beyond those that we are proposing?</p> <p>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?</p>	<p>We are supportive of a whole industry approach to reducing carbon emissions, increasing energy efficiency and addressing other environmental issues. The regulatory system should seek to embed this within the industry as a matter of good business practice rather than through setting incentive driven regulatory targets. Such good practice will be of benefit to passengers, freight users, taxpayers and the environment, which aligns with the ORR's principles for PR13.</p> <p>Supported by funding by the Scottish Government, the rail industry in Scotland is increasing its energy efficiency through areas such as the electrification programme and the purchase of new rolling stock. Therefore the industry should be encouraged to do more to highlight the current, clear environmental benefits of rail passenger travel and moving goods by rail, particularly when compared to car travel and movement by lorry. The regulatory framework must not in any circumstances undermine the rail industry's ability to compete on this basis with other modes, which is a key part of Scottish Government's aspirations for encouraging modal shift.</p>
10.7	We are keen for the industry to propose methodologies for monitoring emissions and producing improved whole-life,	Transport Scotland has already developed a multi-modal Carbon Management System (CMS), and we are

	<p>whole-industry business cases. What role do you think the ORR should play in this process?</p>	<p>working in partnership with Network Rail and ScotRail to measure carbon and emissions from rail. We would welcome the ORR's participation in future development of this work including introduction of a whole life cost element, which could provide a valuable guide for other parts of the GB network.</p> <p>Once sufficient levels of data have been gathered through the CMS, we would hope to continue to engage with the industry in Scotland and the ORR to identify and refine carbon emission reduction trajectories and targets which will help to retain rail's current position as an acknowledged "green" mode of travel.</p>
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