PR13 incentives consultation workshop

9 January 2012

PR13 incentives consultation workshop

Welcome and introduction

Cathryn Ross
Director, Rail Markets and Economics

Purpose of workshop

- To discuss our December 2011 consultation on incentives in PR13
- In particular:
  - Outputs and outcomes
  - Aligning incentives in the context of industry reform
  - Access charges and capacity utilisation
  - Network Rail's financing
  - Disaggregation
- To ensure a good understanding of our thinking…
- … and to get your views
- Closing date for written responses is 8 February
- We need and appreciate your input – thank you for attending

Workshop timetable: morning session

Introduction

- 10.00 Refreshments
- 10.30 Welcome and introduction – Cathryn Ross, Director, Railway Markets and Economics, ORR

Session 1: Establishing and incentivising delivery of outputs and outcomes

- 10:45 Overview of ORR's proposals
- 11.15 Discussion

Session 2: Aligning incentives between NR and operators to increase efficiency

- 11:45 Overview of ORR's proposals
- 12:15 Discussion
- **12:45 Lunch**

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Workshop timetable: afternoon session

Session 3: Access charges and capacity utilisation incentives

- 13:15 Overview of ORR's proposals
- 13:45 Discussion

Session 4: Network Rail's financing arrangements and other incentives

- 14:15 Overview of ORR's proposals
- 14:45 Discussion
- **15:15 Break**

Session 5: Disaggregating NR's price control and financial information by route

- 15:30 Overview of ORR's proposals
- 16:00 Discussion
- **16.30 Wrap-up and close of workshop**

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Session 1: Establishing and incentivising delivery of outputs and outcomes

Cathryn Ross
Director, Rail Markets and Economics

We confirmed our PR13 objective, as in our May consultation

- To protect the interests of customers and taxpayers…
  - … by ensuring our determination enables Network Rail and its industry partners …
  - … to deliver or exceed all the specified outcome and output requirements…
  - … safely and sustainably …
  - … at the most efficient levels possible …
  - … comparable with the best railways in the world …
  - … by the end of the control period.

Within this, we want to focus on what really matters to passengers, freight customers and society

- We want to focus on **outcomes.** These are high level objectives that relate to end-user experience. Their delivery is likely to require the industry to work together.
- Various industry players will need to deliver **outputs** in order to achieve these outcomes. Outputs are more specific and generally deliverable by a particular player.
- We will need to understand the outputs that Network Rail proposes to deliver in CP5 in order to assess the work it will need to do to deliver them and the cost of doing that work
- But we want to see an understanding of how these outputs will drive the outcomes that passengers, freight customers and society care about

What outcomes should we care about?

- We have suggested that we through PR13 we should enable and incentivise the delivery of:
  - Passenger satisfaction
  - Freight customer satisfaction
  - Economic growth
  - Connectivity
  - Environmental sustainability
- There is an overlap with the HLOS. The HLOs that the governments want to buy will reflect their views on outcomes and what drives them
- There is a link to localism and disaggregation. At what level should outcomes and outputs be specified? By what process should disaggregation take place?
- There are trade offs between outcomes, the interests of different groups and current and future generations

We need to understand more about the ‘transmission mechanism’

- Outcomes are generally delivered by the railway working together – so we need to understand the ‘transmission mechanism’ better
- We need to understand more about how our incentives drive Network Rail’s behaviour…
- … and how Network Rail’s interaction with TOCs, FOCs and the supply chain
- .. and their responses
- … drive outcomes
- And we need to take this into account in how we regulate

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Should we measure delivery of outcomes? How should we do this? And what should we do with the measures?

- In CP4 we are monitoring Network Rail's delivery of outputs (safety, network capability, network capacity, network availability, stations, depots, asset serviceability and sustainability and environmental sustainability) using a variety of measures
- We will hold Network Rail to account for the delivery of outputs in CP5. What metrics should we use?
- Should there be more flexibility for Network Rail to deliver different outputs where there is a better way to deliver an outcome? What would this mean?
- Should we also measure and monitor delivery of outcomes?
- Should we hold Network Rail to account for outcomes? At what level should we measure, monitor and hold to account?

We recognise that key ‘enablers’ need to be in place if Network Rail is to deliver efficiently and sustainably

- In CP4 we are monitoring Network Rail’s progress against a number of key enablers:

  Safety, network capacity, network availability and the ‘seven day railways’, stations, depots, asset serviceability and sustainability, environmental sustainability

- We will hold Network Rail to account for the delivery of outputs in CP5. What metrics should we use?
- Should there be more flexibility for Network Rail to deliver different outputs where there is a better way to deliver an outcome? What would this mean?
- Should we also measure and monitor delivery of outcomes?
- Should we hold Network Rail to account for outcomes? At what level should we measure, monitor and hold to account?

Consultation questions: outcomes and outputs (1)

- Q3.1: Do you agree that in PR13 we should focus on incentivising delivery of outcomes that customers, wider society and funders value?
- Q3.2: Do you agree with our assessment of the outcomes that customers and society value?
- 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?
- 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?

Consultation questions: outcomes and outputs (2)

- 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?
- 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?
- 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?

Session 2: Aligning incentives for efficiency improvement

Paul McMahon
Deputy Director, Rail Markets and Economics

Jonathon Hulme
Financial Analyst

We have consulted on approaches to improve alignment between NR and operators to improve efficiency

Purpose

- Recap on the proposals we set out in the consultation document on aligning incentives to improve efficiency, and provide opportunity to discuss

Background

- Implemented a national efficiency benefit sharing (EBS) mechanism as part of PR08, which:
  - provides for operators to share in outperformance achieved by Network Rail
  - is effectively switched off for the majority of franchised passenger operators.
- Consulted in May on two approaches for improving the alignment:
  - developing an improved efficiency sharing mechanism.
  - exposing train operators to Network Rail's costs
- We will cover both approaches in this session

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An improved efficiency sharing mechanism (REBS) should help to overcome misalignment of incentives

Current situation

- Incentives on franchised passenger operators and Network Rail to work together (e.g. benefit of lower costs for customers) are weak – most of Network Rail's customers are, to a large degree, indifferent to its costs
- This is mainly due to:
  - "Schedule 9" in franchise agreements;
  - charges for open access passenger and freight operators are designed to cover only directly incurred / variable costs
  - the nature of the franchise bidding process means that Network Rail's costs are to a large degree passed through to government.
- The current EBS mechanism is switched off for the majority of operators

We are proposing that REBS follows eight principles

- Incentivise passenger and freight train operators to work with NR to identify and help implement opportunities to increase NR’s efficiency
- Provide potential rewards commensurate with the effort put in
- Provide incentives irrespective of whether NR is over or under performing
- Minimise side effects and perverse incentives
- Reflect the financial capacity of each operator involved to bear risk
- Be as transparent and simple as practicable and have administrative costs that are minimised and proportionate to the potential gains
- Not result in undue disadvantage or discrimination
- More generally be consistent with relevant legislation

REBS would operate at a route-level and include upside and downside sharing

<table>
<tr><th>Characteristic of mechanism</th><th colspan="4">Proposal</th></tr>
<tr><td>Level of disaggregation</td><td colspan="4">Network Rail operating route-level (consistent with Network Rail’s accounts)</td></tr>
<tr><td>Efficiencies to be shared</td><td colspan="4">Expenditure and revenues covered are:
•operating, maintenance and renewals expenditure
•property income
•potentially some smaller scale enhancement expenditure</td></tr>
<tr><td>Membership</td><td colspan="4">Compulsory, except where:
•adequate bespoke arrangements are in place
•opt-out for operators that fall below the ‘cut-off’ (or ‘de minimis’ threshold)</td></tr>
<tr><td>Bespoke arrangements</td><td colspan="4">May be a complement to the default mechanism or even replace it</td></tr>
<tr><td>Sharing with Network Rail</td><td>Upside</td><td>25% of outperformance</td><td>Downside</td><td>10% of underperformance</td></tr>
<tr><td rowspan="2">Caps</td><td colspan="4">Financial cap each year, based on NR under / outperformance for each route:</td></tr>
<tr><td>Upside</td><td>10%</td><td>Downside</td><td>10%</td></tr>
</table>

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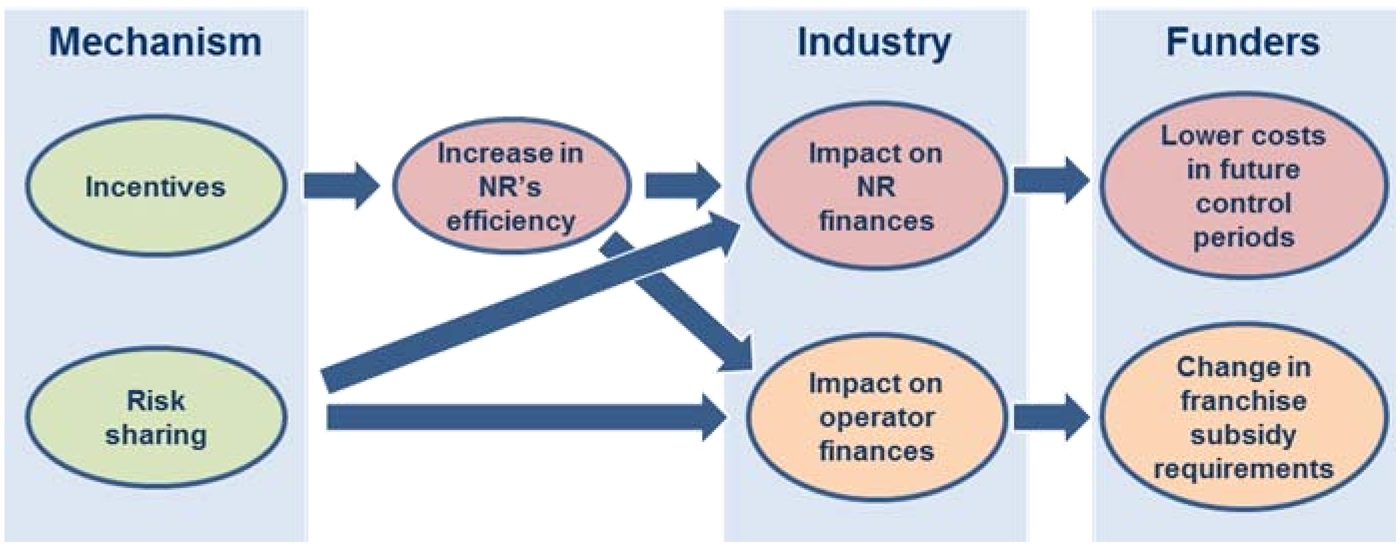
A revised mechanism would impact Network Rail, operators and funders in different ways

- Key impacts are expected to include:
  – an increase in Network Rail's efficiency
  – lower industry costs in future control periods
  – potential financial reward for operators accompanied by a marginal increase in risk
  – possible reduction in future franchise subsidies

Impact of mechanism on rail industry



We also propose to expose operators to Network Rail’s costs at a periodic review

Proposal

- A mechanism that shares Network Rail’s operating, maintenance and renewal cost risk (and potentially risk relative to some Network Rail revenue items), route by route (as determined at a periodic review) with operators for CP6 onwards

Purpose

- Currently operators have little incentive to seek (fixed) cost reductions at a periodic review – this mechanism seek to address this

However…

- This mechanism would only have a financial impact on franchise operators if it were permitted under their franchise agreements

Next steps – REBS and exposure to costs at periodic reviews

- KPMG are undertaking some further modelling on the impact to franchised operators of the proposed route-level efficiency sharing mechanism. We will consider this…
- We are discussing the options with government – and considering how decisions feed into the upcoming franchising competitions

Consultation questions: efficiency benefit sharing (1)

- 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?
- Q4.2: What are your views on our proposed design of a route-based efficiency sharing mechanism, as described in this chapter 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?
- 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?

Consultation questions: efficiency benefit sharing (2)

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

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Session 3: Access Charges and Capacity Utilisation Incentives

Emily Bulman
Head of transport Economics

Access charges

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We are consulting on bespoke arrangements for charges

- Network Rail has responsibility for calculating charges; we audit and approve its charges
- We consulted on track access charges in May 2011; we will conclude on the issues we raised in April this year
- In the incentives consultation we specifically focus on the issue of bespoke charges
  - the circumstances in which we should approve charges that are not calculated on the basis of the approved methodology
  - How existing arrangements should be treated at a subsequent periodic review of Network Rail
- Note that EU legislation requires charges to be based on costs directly incurred (+ mark up)

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We propose to establish principles to which bespoke charging arrangements should adhere

Suggested principles:

- the charge is agreed by the operator and Network Rail
- the charge is calculated using the same overarching principles that underpin the periodic review charging models
- the evidence provided is objective, transparent and well founded
- the associated reduction in charges calculated can be applied in a way that does not result in undue discrimination

Consultation questions: bespoke arrangements

- 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?

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

- 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?

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

Capacity utilisation incentives

Why reform capacity utilisation incentives?

- If there is a problem with how capacity is used currently: is there evidence that capacity is being under-used, or used inefficiently?
- If the mechanisms for allocating capacity could be improved: could market mechanisms complement and / or improve on current administrative procedures?
- If capacity allocation procedures and incentives require updating to complement other reforms to the industry in particular franchise reform

The existence of any or all of these conditions does not in itself justify reform. We will need to consider whether the benefits of any proposed reform exceed its costs, taking into account risks and potential unintended consequences

Proposals for different mechanisms (1)

We consulted on capacity utilisation incentives in May 2011; this consultation builds on that work, the responses we received and associated stakeholder engagement

- We will review the **volume incentive**, which is the incentive for Network Rail to accept extra traffic onto the network. We propose to disaggregate it by Network Rail route
- We continue to support the rationale for the **capacity charge**, which reflects costs associated with reactive delay
- We do not intend to consider an option for Network Rail to **share train operators' revenue** further as part of PR13
- We are not minded to proceed with a **reservation charge** as part of PR13, though are conducting further research on path utilisation to confirm our view

Proposals for different mechanisms (2)

- In our May 2011 consultation, we **considered a charge levied to incentivise better use of capacity**. We consider it further in this consultation
- We commissioned consultants NERA to consider charges to incentivise efficient use of capacity, and held a small workshop to discuss their work in September 2011. We note:
  - charges would need to be set conservatively, potentially at zero for much of network and day, in order to prevent capacity being under utilised
  - complex charges create difficulties for billing and quoting to freight customers
  - higher variable charges may better share risk between Network Rail and franchise operators
- Prior to any implementation we would need to:
  - consider and address any practical difficulties that arise from such a charge
  - conduct an impact assessment, underpinned by forecasts as to how such a charge would affect different markets
- We welcome further views on the policy we are considering further to **levy a charge to incentivise better use of capacity**

Consultation questions: capacity utilisation

- Q7.1: What are your views on our:
- (a) proposed review of the volume incentive, including disaggregation by Network Rail route and consideration of a down side as well as an upside?
- (b) continued support for the rationale for the capacity charge, and support for Network Rail’s work to revisit and recalibrate the charge?
- (c) suggestion to establish the extent to which infrastructure capacity is under-utilised before deciding whether to proceeding to develop one or more indicator by which to monitor capacity utilisation?
- 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?

Next steps on charges / CU incentives

- We will conclude on these high level issues when we publish our regulatory framework for PR13, following the publication of our Advice for Ministers documents in March 2012
- At the same time, we will conclude on the high level charging issues that we consulted on in May 2011, and on our on-rail competition consultation
- We are conducting a number of studies:
  - NERA study on capacity utilisation incentives to be published shortly
  - Study of paths not used (relating to reservation charge)
  - Study of extent of inefficiencies in capacity utilisation
- Continue monthly engagement with stakeholders at PR13 VTAC development meetings, plus other industry and bilateral meetings

Session 4: Network Rail's financing arrangements and other incentives

Carl Hetherington
Head of Regulatory Finance

Rob Mills
Senior Economist

Richard Owen
Economist

Purpose

- The main purpose of this session is to discuss Network Rail ‘s cost of capital and financing arrangements. This is the financial framework issue most closely linked to general incentive issues. Linked to this is the issue of the incentive properties of opex and capex cost recovery
- We would also like to discuss our proposed approach to Schedules 4 and 8
- Finally, we would like to canvass opinion on our proposed approaches to innovation and environmental incentives

Network Rail’s financing arrangements

Context

- Network Rail's CLG status and its use of the FIM have a significant impact on the way in which they respond to incentives. In particular:
  - creditors are not at risk, so do not undertake their normal monitoring role
  - there is no hard budget constraint
- In PR08 we assumed Network Rail would issue unsupported debt
- Changes since PR08:
  - worse economic climate
  - current and prospective industry reforms, e.g. concessions
  - Network Rail's devolution and operating strategy
- This is material – Network Rail's allowed return in 2011-12 is c£2bn

Overall approach to regulating Network Rail

- Treat Network Rail as a CLG that has debt guaranteed by government
  - this assumes that Network Rail would be more motivated by minimising downside risk and would be more responsive to reputational rather than financial incentives
  - this would be consistent with a cost of debt approach

- Try to improve Network Rail's incentives. This is the approach we took in PR08 where we treated Network Rail as if it was a conventionally financed company but took account of its specific characteristics, e.g. through the use of the ring-fenced fund

Consultation questions: Network Rail financing

- 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?
- 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?
- Q8.3 How do you think we should deal with the surplus cash that results from such an approach?
- 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?
- Q8.5 How should we strike the right balance between the interests of current customers and funders and future customers and funders?

Key issues

- Network Rail’s cost of capital should reflect all its risks
- Network Rail’s cost of financing is lower than its cost of capital
- Therefore, we need to decide:
  – should Network Rail’s allowed return reflect its cost of capital
  – how the difference between the cost of capital and the cost of finance should be treated
  – how should network Rail be financed, e.g. should it raise unsupported debt

Criteria

- Impact on incentives
- Transparency – our approach should identify the full cost of Network Rail's activities
- Flexibility to change Network Rail's financing structure
- Financial sustainability – is the level of debt appropriate and are there any inter-generational issues
- Affordability – is the net revenue requirement affordable by funders over time
- Tension between improving affordability for funders and sustainability of Network Rail's finances in the long term – especially given increased pressure on public finances

Options

- Assume Network Rail issues unsupported debt
  - In this approach we provide Network Rail with an allowed return that reflects its cost of capital
  - This approach would improve incentives, transparency and flexibility to change Network Rail's financing structure
  - The surplus cash could be either:
    - re-invested in the network, i.e. the PR08 approach. The net funding requirement would be £6bn higher than under a cost of debt approach but this would be offset by lower debt, this reduces funding in later control periods
    - rebated back to government. This is similar financially to the cost of debt approach
- Assume Network Rail does not issue unsupported debt (cost of debt approach)
  - In this approach we just finance Network Rail's efficient financing costs
- The main difference between the various approaches is the timing difference between the net funding requirement in CP5 and later control periods

Note: In Network Rail's IIP it assumed that the allowed return would be based on a cost of capital and there would be a ring-fenced fund but it did not assume it would issue unsupported debt

Opex and capex cost recovery

- Our regulatory framework should not distort incentives on Network Rail
- How do the incentive properties of our treatment of opex and capex affect operating decisions on the ground
- How should the incentives on Network Rail be calibrated, i.e. should they be equal across all expenditure types and over time and how we do take account of the recurring nature of some savings
- Network Rail is not as incentivised as other regulated companies to maximise profit. It is more incentivised to achieve its efficiency targets
- Therefore, should we widen our efficiency reporting so that it includes other types of income and expenditure as well as support, operations, maintenance and renewals expenditure

Next steps

- Include two scenarios in our advice to ministers document reflecting the two options
- Conclude on our approach to Network Rail's cost of capital and financing arrangements in April
- Consult on other financial framework issues in April
- Conclude on the incentive properties of opex and capex cost recovery in October

Schedule 4 & 8

Schedules 4 and 8

- In July 2011 we held a workshop to discuss Schedule 8 and in November 2011 we held a workshop to discuss Schedule 4.
- As a result of further developments in our thinking, responses to our May 2011 consultation and other discussions with stakeholders, we pose some additional questions in our December 2011 consultation and outline. We also outline our next steps
- Here will briefly summarise additional questions
- Opportunity to comment on them as part of our general discussion at the end of this session

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As compensation regimes…

- Primary role is as compensation regimes
  – Are train operators correctly compensated for service disruption due to poor performance and possessions?
- We propose to:
  – Update payment rates so they reflect current evidence on the impact of service disruption on revenue and costs
  – Review whether to introduce a time delay on payments in the Schedule 8 passenger regime to reflect fact that the impact of performance on revenue goes beyond the short term
  – Review whether payment rates should be set at a level below 100% compensation to encourage co-operation between train operators and Network Rail

Incentive properties

- Schedules 4 and 8 help align financial incentives between Network Rail and train operators
  - Financial impact of disruption on a train operator's revenue and/ or costs is incurred by the organisation that the disruption is attributable to
- However,
  - Some customers of train services do not have suitable alternatives meaning they will continue to use services even if heavily disrupted or performance is poor
  - Positive impact of train services on non-users
- We therefore ask if existing incentives on Network Rail (S4 and S8 or otherwise) are enough

Schedules 4 and 8 in a more joined up industry

- We discuss the roles of Schedules 4 and 8 in a more joined up industry, in particular whether stakeholders:
  - Envisage any barriers to bespoke S4 and S8 regimes
  - Agree with our view that we should only approve bespoke Schedule 4 and Schedule 8 arrangements where we are satisfied that they do not undermine the incentives on Network Rail and train operators to work together to meet performance standards and minimise disruption due to planned possessions.

Consultation questions: Schedules 4 & 8 (1)

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

Consultation questions: Schedules 4 & 8 (2)

- 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.
- 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?

Innovation and environmental incentives

Innovation

- McNulty suggested that £190m of the ‘McNulty billion’ could be derived from innovation-related efficiencies.
- We therefore want to provide the industry with incentives to introduce innovative solutions where they are appropriate.
- In PR08, we employed an output-based approach, which was neutral with regard to innovation.
- The IIP proposes a specific innovation fund to encourage innovation in certain key areas.

Comparison of different approaches

PR13 Policy Choice

	Specific innovation incentives	Output-based approach
+	Targeted at specific problems	Focus on outputs – neutral
-	Subjective ‘beauty contest’	May encourage risk averse behaviour

Our Proposal

- Our preference is to retain an output-based approach to innovation, in contrast to the IIP proposal.
- We remain open-minded to alternative approaches. The challenge to industry will be to demonstrate that an alternative approach is necessary, and will deliver both improved outputs and improved outcomes compared to an output-based approach.
- We would therefore like the industry to set out in more detail the areas where they feel specific funding approaches are required, and its proposals for administering them.

Consultation questions: innovation

- Q10.1 Do you agree with our overall proposed approach to incentivising innovation? If not, what do you propose we do instead?
- Q10.2 What merit do you think there would be in an innovation fund? How should such a fund work? How should we guard against ‘crowding out’ and ensure that the fund did not displace existing expenditure?
- 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?
- 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?
- Q10.5 Do you think that KPIs should be introduced for companies other than Network Rail to monitor innovation across the wider industry?

Environmental Incentives

- Rail is well placed to contribute to an overall reduction in the UK's carbon emissions.
- We need to set incentives that are consistent with overall reduction in carbon consumption.
- Our focus is therefore on incentives that are consistent with a lower cost railway, such as improved energy consumption (though increased use of energy metering), as we feel that a lower cost railway will drive improved environmental performance overall.
- We are also supportive of the IIP's 'Carbon Management Framework' proposal.

Consultation questions: environmental incentives

- 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?
- 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?

Session 5: Disaggregating NR's price control and information by route

Carl Hetherington
Head of Regulatory Finance

Purpose and context

- Purpose of this session – to provide more clarity on our approach to price control separation
- Network Rail is devolving a significant amount of responsibility for the management of its network to its operating routes to improve its responsiveness to customers at a local level
- This means that route managing directors will be responsible for:
  - Safety,
  - All customer service matters
  - Asset management outputs and spend
  - Operations
  - Planning and delivering maintenance
  - Delivery of some renewals and enhancements
- The centre will ensure that the railway continues to be planned and operated as a network
- Network Rail Route Managing Directors are preparing Network Rail's SBP from the route level up
- Network Rail has long established route plans (inc expenditure) and it should know where it needs to do work
- Devolution will be supported by the publication of audited operating route level financial information for 2011-12 onwards

What does price control disaggregation/separation mean?

- ‘Price control separation’ can mean many different things to different people
- Three levels:
  - Inform, e.g. accounting information by operating route
  - Assess, e.g. efficient expenditure assumptions by operating route
  - Determine, e.g. England & Wales and Scotland are separate

May consultation questions

- Q3 Do you think that our approach to the disaggregation of Network Rail financial (and other) data to operating route is appropriate? Is the information we are requiring Network Rail to produce set at the right level? Do you have views on the information train operators should produce?

- Q4 Which aspects of the price control should be separated for England & Wales and Scotland, e.g. should the efficiency assumption be separate?

- Q5 Do you think there should be further separation of the price control for Network Rail's operating routes and, if so, which aspects of the price control should be separated?

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Consultation responses

- There was substantial support for greater disaggregation and improved transparency of data
- Some stakeholders suggested that all aspects of the price controls for England & Wales and Scotland should be separated. However, there were some concerns linked to this support, e.g. how efficiencies within England & Wales and Scotland will be dealt with and that further disaggregation may incur higher costs in Scotland.
- There was also a good level of support (though not from the freight sector or CrossCountry) for further disaggregation of the price control (e.g. to an operating route level) and a risk sharing approach was preferred
- There was also a recognition of potential problems especially for operators who run across route boundaries, e.g. would it be too complex

Overall approach

- More transparency by operating route, e.g. regulatory accounts and whole industry financial reporting
- Our assumptions as far as possible should be by operating route
- Where possible we will make determinations by operating route

England & Wales and Scotland

- Separate price controls for England & Wales and Scotland already include:
  – a risk bearing approach is used, i.e. underperformance or outperformance is ultimately borne or retained entirely separately by customers and funders in each area
  – separate revenue requirements (including RAB, debt, expenditure)
  – separate outputs
  – separate access charges (but a GB wide variable usage charge price list)
  – separate provisions for dealing with risk and uncertainty (although the framework is largely the same)
  – separate monitoring and enforcement
- What more can we do:
  – efficiency assumptions – we are working on producing separate efficiency assumptions
  – cost of capital – we will assess whether there should be different assumptions
  – financeability - we will assess whether there should be a different assumptions
  – where possible the incentives will be separate (but may be the same where appropriate) as we are aiming to have incentives that are appropriate for each area
  – at the moment there is no need for a separate licence

Operating routes (1 of 3)

- Financial separation
  - At the moment a risk sharing approach is favoured
  - Shadow RAB and debt to be calculated to aid transparency and provide a basis for any further development

- Revenue requirements
  - unlike Scotland there is no separate funding of operating routes, so not yet essential to produce separate revenue requirements by operating route:
    - expenditure – we will assess by operating route and publish our assumptions
    - efficiency - we are assessing whether we would be able to produce robust efficiency determinations at an operating route level
    - cost of capital and financeability - we will assess whether there should be different assumptions across operating routes

Operating routes (2 of 3)

- Outputs
  - Some outputs already disaggregated
  - Can we combine them into operating route outputs to support regional efficiency benefit sharing
- Access charges
  - Most charges are already disaggregated
  - We are considering the pros/cons of disaggregating the variable usage charge to the route level (recognising that for, e.g., freight a national price list could be retained)
- Incentives
  - REBS and volume incentive to be disaggregated by operating route

Operating routes (3 of 3)

- Provisions for dealing with risk and uncertainty
  - Largely depends on the approach to financial separation discussed above. At the moment we do not think separate provisions are needed
- Monitoring and enforcement
  - Our monitor and annual assessment could report on an operating route basis
  - Unlikely to have a separate licence for each operating route. If outputs are on an operating route basis then enforcement would be as well

Key issues for discussion/next steps

- Is our overall approach right?
- What outputs can be set on an operating route level, e.g. delay minutes?
- Disaggregated expenditure assumptions:
  – how robust do we need them to be and how robust will they be?
  – who produces them, i.e. ORR or NR in its delivery plan?
- What are the implementation issues?
- Next steps – conclude on our approach in April

Consultation questions: disaggregation of NR's price control (1)

- 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?
- Q4.2: What are your views on our proposed design of a route-based efficiency sharing mechanism, as described in this chapter 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?
- 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?

Consultation questions: disaggregation of NR’s price control (2)

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

End of presentation: Any questions?