

Alliancing & REBS in CP5: Introduction

Peter Swatridge

Purpose and aim of workshop

- The **purpose** of today's workshop is to:
 - share understanding of the options for REBS in the context of alliancing;
 - demonstrate the features of the options by means of practical examples; and
 - establish some principles which could be used by ORR to decide between the options.
- The **aim** of the workshop will be to try and arrive at an industry agreed position on how REBS and alliances should work together, to help ORR make a decision in relation to this matter.
- The Metering Steering Group is a good example of the industry coming together to come to some consensus positions in response to ORR consultations.

Purpose and aim of workshop

- The focus of the workshop is on how REBS and alliancing should interact.
- Throughout the workshop, we will assume ORR's 'minded to' position on the structure of REBS.
- Whilst important, discussions about areas such as
 - Asymmetry of REBS;
 - Scope of REBS; and
 - compulsory membership of REBS

are outside of scope for today, except to the extent that they are relevant to the interaction of REBS and alliancing.



Alliancing & REBS in CP5: Setting the scene

Joel Strange

Purpose

- To recap on the principal features of ORR's proposed REBS regime.
- To illustrate why REBS is important in the context of alliancing.
- To recall the options being considered by ORR in relation to how REBS and alliancing should interact, and help ensure that everyone is on the same page.

This first session is intended to be factual in nature. The aim is to promote common understanding of the proposals and issues to provide the foundation for debate later on.

Recap: Proposed structure of REBS in CP5

- Like alliancing, REBS is a financial sharing mechanism.
- Similar to the EBSM framework for CP4, but based on route geographies.
- ORR's 'minded to' position is that Network Rail shares 25% of outperformance and 10% of underperformance of regulatory targets with operators.
 - For example, if a route had a baseline or 'target' of £500m OMR but outturn expenditure of £450m, 25% of £50m (£12.5m) of outperformance would flow to operators.
 - If outturn expenditure was £550m, operators would pay Network Rail 10% of the £50m (£5m) underperformance.
- REBS will be subject to caps, and payments will be made in cash annually.

Why is REBS important in the context of alliancing?

- Through REBS, ORR wants to establish default arrangements for:
‘strengthening and aligning the incentives between Network Rail and train operators to work together to improve cost efficiency’.
- This objective is practically the same as Network Rail’s stated purpose of alliances:
‘to achieve improvements in value for money by enabling more effective cooperation or partnership with operators’.
- That alliances and REBS occupy the same space means that there are important interactions between them.
- The central question is: which should take precedence? i.e. should alliance payments take place before REBS payments, or *vice versa*?

Options for REBS & deep alliances in CP5

- The interaction of alliancing and REBS is important and will lead to different outcomes (depending on what approach taken).
- Two options are being considered by ORR:
 - **Option A** – Network Rail’s alliance baseline is used to calculate REBS (REBS before alliance).
 - **Option B** – Alliance credit and debits taken into REBS calculations (Alliance before REBS).

Illustration 1

<i>All figures are costs</i>	NR	Alliance TOC	Alliance Total
Alliance baseline	100	90	190
Outcome	90	60	150
Gross efficiency (alliance baseline – outcome)	10	30	40
50% of alliance total gross efficiency			20
Alliance (credits) / debits	(10)	10	
Net Outcome	80	70	150
Net efficiency (alliance baseline – net outcome)	20	20	40

Option A
(REBS before alliance)

REBS Calcs

Option B
(Alliance before REBS)

Illustration 2

<i>All figures are costs</i>	NR	Alliance TOC	Alliance Total
Alliance baseline	100	90	190
Outcome	110	70	180
Gross efficiency (alliance baseline – outcome)	(10)	20	10
50% of alliance total gross efficiency			5
Alliance (credits) / debits	(15)	15	
Net Outcome	95	85	180
Net efficiency (alliance baseline – net outcome)	5	5	10

Option A
(REBS before alliance)

REBS Calcs

Option B
(Alliance before REBS)

Summary

- **Option A** – REBS payments made on the basis of Network Rail's financial performance relative to baseline on a particular route

- **Option B** – REBS payments determined by the performance of Network Rail **including alliance contributions**

Supplementary slides

Options A and B: Some facts

Option A	Option B
REBS payments made on the basis of Network Rail's financial performance relative to baseline on a particular route	REBS payments determined by the performance of Network Rail including alliance contributions
£100 saved in the alliance party's cost base yields £50 of financial benefits to both Network Rail and the alliance operator	£100 saved has same financial impact on Network Rail and alliance operator, regardless of 'where' it is saved
£100 saved in Network Rail's cost base yields £37.50 of financial benefits each to Network Rail and the alliance operator	
Third party operators indirectly exposed to alliance operator's costs	Third party operators directly exposed to alliance operator's costs
Third party operators rewarded for cost savings in Network Rail's cost base	Third party operators rewarded for savings anywhere in alliance's cost base
Third party operators encouraged to help make savings in Network Rail's cost base	Third party operators encouraged to help make savings in the cost base of the alliance as a whole

Addendum: Principles

- Alliances should not be incentivised against 'doing the right thing'
- Transactions costs should be minimised
- Risks to third party operators should be kept to a minimum
- All parties on a route should be incentivised to assist in the success of the alliance *as a whole*
- Arrangements should not encourage discrimination
- ORR regulation of operators should be kept in check

REBS and alliancing

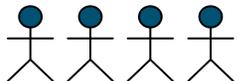
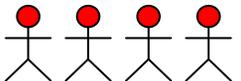
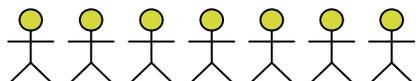
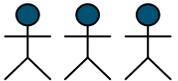
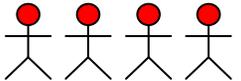
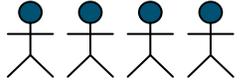
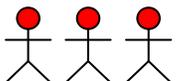
- Alliance TOC accounts for 80% of route VUC
- Minority train operator accounts for 20% of route VUC
- Assume REBS per ORR's favoured structure (25% upside, 10% downside). Assume no caps for simplicity of worked examples !
- 50/50 alliance sharing between NR and alliance TOC
- Consider:
 - REBS before alliance; and
 - Alliance before REBS.

SCENARIO 1



 £40k p.a.

 £40k p.a.

	NR	All. TOC	TOTAL (£)	SAVING (£)
Current			320k	
'Needed'				
Possibility 1			280k	40k
Possibility 2			280k	40k

REBS before alliance

- Consider minority operator point of view
- Consider alliance point of view

REBS before alliance

- Consider minority operator point of view

Possibility 1: £40k x 25% x 20% = £2k to minority TOC

Possibility 2: £0k to minority TOC

REBS before alliance

- Consider alliance point of view

Possibility 1: £40k - £2k = £38k to alliance

Possibility 2: £40k to alliance

Alliance before REBS

- Consider minority operator point of view

- Consider alliance point of view

Alliance before REBS

- Consider minority operator point of view

Possibility 1: £40k x 50% x 25% x 20% = £1k to minority operator

Possibility 2: £40k x 50% x 25% x 20% = £1k to minority operator

Alliance before REBS

- Consider alliance point of view

Possibility 1: £40k - £1k = £39k to alliance

Possibility 2: £40k - £1k = £39k to alliance

OBSERVATIONS

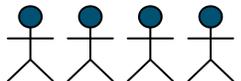
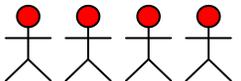
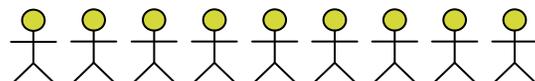
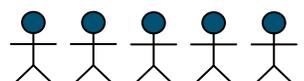
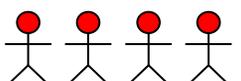
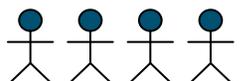
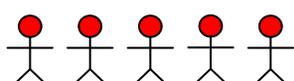
- Design of REBS could mean that it matters where costs are saved
- Design of REBS could lead to incentives to make cost savings in one party over another
- Alliance can make savings overall, but design of REBS could lead to minority operator impact being very different

SCENARIO 2



 £40k p.a.

 £40k p.a.

	NR	All. TOC	TOTAL (£)	SAVING (£)
Current			320k	
'Needed'				
Possibility 1			360k	-40k
Possibility 2			360k	-40k

REBS before alliance

- Consider minority operator point of view

- Consider alliance point of view

REBS before alliance

- Consider minority operator point of view

Possibility 1: $-\text{£}40\text{k} \times 25\% \times 20\% = -\text{£}2\text{k}$ to minority operator TOC

Possibility 2: $\text{£}0\text{k}$ to minority operator TOC

REBS before alliance

- Consider alliance point of view

Possibility 1: $-\text{£}40\text{k} + \text{£}2\text{k} = -\text{£}38\text{k}$ to alliance

Possibility 2: $-\text{£}40\text{k}$ to alliance

Alliance before REBS

- Consider minority operator point of view

- Consider alliance point of view

Alliance before REBS

- Consider minority operator point of view

Possibility 1: $-\text{£}40\text{k} \times 50\% \times 25\% \times 20\% = -\text{£}1\text{k}$ to minority
TOC

Possibility 2: $-\text{£}40\text{k} \times 50\% \times 25\% \times 20\% = -\text{£}1\text{k}$ to minority
TOC

Alliance before REBS

- Consider alliance point of view

Possibility 1: $-\text{£}40\text{k} + \text{£}1\text{k} = -\text{£}39\text{k}$ to alliance

Possibility 2: $-\text{£}40\text{k} + \text{£}1\text{k} = -\text{£}39\text{k}$ to alliance

OBSERVATIONS

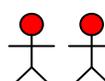
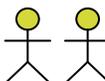
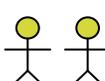
- Design of REBS could mean that it matters where costs increase
- Design of REBS could lead to incentives to increase costs in one party over another
- Design of REBS could lead to minority operator impact being very different

SCENARIO 3



 £40k p.a.

 £40k p.a.

	NR	All. TOC	TOTAL (£)	SAVING (£)
Current			120k	
'Needed'				
Possibility 1 (only option)			80k	40k

REBS before alliance

- Consider minority operator point of view
- Consider alliance point of view

REBS before alliance

- Consider minority operator point of view

Possibility 1: $-\text{£}40\text{k} \times 10\% \times 20\% = -\text{£}800$ to minority TOC

REBS before alliance

- Consider alliance point of view

Possibility 1: £40k + £2k = £42k to alliance

Alliance before REBS

- Consider minority operator point of view

- Consider alliance point of view

Alliance before REBS

- Consider minority operator point of view

Possibility 1: £40k x 50% x 25% x 20% = £1k to minority operator

Alliance before REBS

- Consider alliance point of view

Possibility 1: £40k - £1k = £39k to alliance

OBSERVATIONS

- Under 'alliance before REBS', if the alliance outperforms the minority operator always gains

- Under 'REBS before alliance', even if the alliance outperforms the minority operator could still be worse off

SCENARIO 4



£25k p.a. – skills X & Y



£40k p.a. – skills X, Y & Z

	NR	All. TOC	TOTAL (£)	SAVING (£)
Current			260k	
'Needed' (skills X, Y & Z)				
Possibility 1			160k	100k
Possibility 2 (Year 1)	+ £10k per head training		140k	120k
Possibility 2 (Year 2)			100k	160k

OBSERVATIONS

- Under REBS before alliance, minority operator would prefer possibility 1
- Under alliance before REBS all parties would prefer possibility 2