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Dear Cathryn

Route-level efficiency benefit sharing: response to December 2012 decisions

I am writing in response to your December 2012 publication *'Aligning Incentives: Decisions on route-level efficiency benefit sharing (REBS) and train operator exposure to Network Rail's costs at periodic review'*, and your letter, dated 17 December 2012, on principles for setting expenditure baselines for the REBS mechanism in CP5.

On a number of occasions during the current periodic review, ORR has acknowledged the benefits of improving alignment between Network Rail and its customers. Working together through alliancing, along with devolution, is one of the key enablers of continued improvement in efficiency. In our response to ORR's aligning incentives consultation, we stressed the need for ORR to establish a regulatory framework for CP5 that rewards joint working and incentivises operators to support Network Rail's efficiency incentives. We welcome many of ORR's decisions in relation to the REBS mechanism which we consider will assist in achieving this goal.

There are, however, three key aspects of the REBS regime that remain to be resolved:

1. Setting the REBS baselines and how they will be applied;
2. Scope of REBS; and
3. Changes in traffic growth / demand.

The purpose of this letter is to set out our views on these issues and propose a way forward. We note that you will consult on the methodology for assessing Network Rail's efficiency in June 2013 (which will include further consideration of the methodology for setting the REBS route-level baselines and the way in which they are applied). We would, therefore, welcome further discussion with you on these areas at the earliest opportunity.

1. Setting the REBS baselines

Your letter acknowledges our discussions to-date about setting route-level expenditure baselines, and that our preferred approach would be that ORR does not set the route-level baselines but leaves Network Rail some flexibility to do so (e.g. through the CP5 delivery plan) and that the baselines are not fixed *ex ante* for the duration of the control period. In particular, we consider that there would be considerable merit if the REBS mechanism allows route baselines to be adjusted both before and during the control period, if the circumstances merit it.

We note, and agree, with the majority of the principles for the route level baselines for REBS that you set out in your letter which we discuss in further detail, below. We continue to be deeply concerned, however, with the possibility that route-level expenditure baselines will be fixed at the start of CP5, for the duration of the control period.

We acknowledge the need for transparency and simplicity so that the mechanism is easily understood by those it is designed to incentivise. We do not consider, however, that this precludes the possibility of making adjustments to the baselines (which could be done through the annual delivery plan updates) to reflect changing circumstances. We propose, below, that the original baselines would be retained for complete transparency and that these would continue to be reported against, but adjusted baselines could also be established and that these would be used in subsequent REBS calculations.

Furthermore, if ORR fixes the route-level baselines in its Final Determinations, we are concerned by the impact this could potentially have on our incentives to act in an open and transparent way with operators. Since operators will be able to opt-out of the mechanism at the beginning of the control period, we could be faced with a perverse incentive to conceal information from operators for those routes where we consider the efficiency baselines to be particularly challenging (otherwise they would be likely to opt-out) and for those routes where we consider the efficiency baselines to be less challenging (who would enter into REBS). This behaviour would, of course, be very undesirable, and while we could seek to avoid this, we consider that the design of the mechanism should not create such a perverse incentive.

Route 'geographic' constraints

As your letter states, without some form of intra-control period flexibility, we would be concerned that there could be windfall gains and losses to train operators or Network Rail across different routes. Given that operators will be able to opt-out of the REBS mechanism at the beginning of CP5, some operators may perceive the potential for windfall losses to be too risky and opt-out of REBS on that basis.

A less flexible mechanism could also prevent changes which improve efficiency by placing constraints on 'how' we do things across particular routes, for example changes in route boundaries. Although this may not be a frequent event it would be of great concern if there was no mechanism to enable this during control periods, even where the business case to do so is clearly beneficial.

Another example would be if we were to change our charging structure for ballast from a national rate to route rates, to better reflect the regional variations in distribution costs. If we did not have any flexibility around the REBS baselines, this would result in windfall gains and losses across different routes. This would create opponents to improved efficiency which is precisely what we are seeking to avoid. Combined with the REBS asymmetry it could mean that Network Rail is made worse off as a result of an initiative which improves efficiency across the whole network. This could therefore disincentivise us from making the change, and thus running our business in a more efficient way.

Temporal constraints

We consider that in setting the REBS baselines *ex-ante*, each route will be constrained by a pre-defined trajectory for the control period that may undermine incentives to undertake a particular efficiency initiative. It may be the case, for example, that a route identifies a particular efficiency that requires a financial outlay in the first year and pays back in subsequent years. In the absence of flexibility to adjust the REBS baseline, this could translate into underperformance in one year and outperformance in another. Because of the asymmetry of the REBS mechanism, this could undermine the apparent business case for the investment.

Increase in costs

As the REBS mechanism will be asymmetric, any windfall gains that result in REBS payments to train operators on a particular route would result in a net cost to Network Rail even when national efficiency targets have been achieved.

Our response to the May 2012 consultation included analysis suggesting that an asymmetric mechanism would result in a material cost to Network Rail of £70million for the control period, for which we considered it would be appropriate to be remunerated. This analysis made the assumption that we would have the flexibility to make changes to the REBS baselines. We have now revisited this analysis to understand the effect of setting the baselines for the entire control period. Our indicative review has suggested that by fixing the REBS baselines, the cost to Network Rail could increase significantly. We are concerned by the financial risk that this would import to the business.

Incentive properties

We are also concerned about the potential impact on incentives of fixing the REBS baselines for the duration of the control period in combination with an asymmetric mechanism. For instance, if Network Rail appears to be underperforming on a route merely because of a necessary rebalancing of budgets, the marginal incentive strength on operators to work with Network Rail to improve performance for that route would be lower than if the route's baseline were reset.

Proposal

Given the above concerns and the associated financial risks, we are strongly of the view that the principles set out in your letter should not preclude Network Rail from adjusting the initial REBS baselines. Moreover, they should not prevent intra-control period adjustments, which could be to route baselines in a particular year and / or across different years in the control period. In the following section, we discuss our preferred approach in more detail, including how it is consistent with the principles set out in your letter of 17 December 2012.

Setting the initial REBS baselines

As you acknowledge in your letter, our preferred approach to setting the initial route-level expenditure baselines for REBS in CP5 would be for ORR to allow us some flexibility, subject to industry engagement and conditional on ORR approval, as discussed below. We have previously proposed that the finalised numbers could be included in the CP5 Delivery Plan, which is due to be published just before the beginning of the new control period. As noted above, however, the original baselines could be retained and reported against with the adjusted baselines which would be used for REBS purposes.

We would anticipate a consultative process in the formation of the baselines, leading up to the CP5 Delivery Plan publication, which would be conditional on approval by ORR. Through our industry engagement, we would be transparent and provide simple explanations of the process.

I note that if the overall level of efficient expenditure is taken as given, Network Rail has no incentive other than to get the allocation of expenditure allowances to routes 'right'. This should give ORR assurance that the process is workable.

Intra-control period adjustments

We recognise why fixed baselines for the duration of the control period could be desirable for reporting purposes, in particular to provide a consistent and transparent measure of how Network Rail is performing against the assumptions made in the Final Determinations and its commitments in the CP5 Delivery Plan.

As discussed above, however, we have a number of concerns particularly the potential windfall gains and losses that could result to both Network Rail and operators from the route 'geographic' and temporal constraints of fixed route-level baselines. We consider, therefore, that it would be appropriate to have the ability to propose annual adjustments to the previous year's baselines (in accordance with pre-determined principles) but also to include the unadjusted CP5 baselines in our reporting, for the purposes of comparison.

Cost neutrality

We consider that a key principle when proposing any adjustments to the REBS baselines, either by geography or time, would be that they are financially cost neutral when compared with the national efficiency baseline as defined in the PR13 Final Determinations. We note that this would be consistent with regulatory precedent from other industries where tariff rebalancing, subject to overall caps, is common practice. Royal Mail, for example, is permitted to annually rebalance its tariffs across defined services, subject to an overall RPI-X price cap.

Proposed process for making adjustments

As you will be aware, the purpose of the annual Control Period Delivery Plan Updates (DPUs) is not to reopen our plans of delivering the Final Determinations for the control period, but to provide an update on certain areas where more detail has become available and importantly where circumstances have changed over the preceding year (for example, where opportunities to realise further efficiencies have been identified). We propose, therefore, that any adjustments could be 'locked down' for the following year in the annual CP5 DPUs, and would be subject to prior consultation with industry and be conditional on ORR's approval.

During CP4, the DPUs for each financial year of the control period have been published in the preceding February or March. Assuming no change in the process, we consider that industry consultation on any adjustments to the REBS baselines, using actual year-to-date figures and any new information that has come to light regarding future efficiencies for a particular route, could be carried out in the preceding December. We could then seek approval from ORR ahead of the publication of the DPU for the following financial year. Part of this process would be to demonstrate that any proposed adjustments to the route baselines would be cost-neutral overall.

Principles-based approach

I understand that the importance of principles governing the approach to establishing REBS baselines and how they will be applied was discussed at a recent stakeholder discussion at ORR's offices on 28 January 2013. We fully acknowledge that to minimise the potential issues with gaining industry agreement and ORR's approval for setting the REBS baselines and for proposing any subsequent adjustments, we must adhere to pre-determined principles.

Your letter of 17 December 2012 sets out a number of principles, and concluded that in view of these, you were currently of the view that it would be difficult to develop a process which allows for material in-control period changes to REBS route-level baselines. I thought that it would be helpful to take each of the principles in your letter, in turn, and explain how we consider that our proposal is consistent with them:

- *ORR is ultimately responsible for approving REBS expenditure baselines*

  We have proposed that, following industry consultation, the initial REBS baselines and any subsequent adjustments that we propose would be conditional on ORR's approval.

- *Baselines should be set before the start of the control period and take into account feedback from other industry participants.*

  As discussed above, we have proposed that we would have the flexibility to adjust the initial route-level REBS baselines in the CP5 Delivery Plan, following consultation with industry and ORR approval. In proposing any further adjustments, we would do so on an annual basis (for example, in our annual Delivery Plan Updates), which would be preceded by industry consultation and approval by ORR.

  We have also proposed that the original ORR unadjusted baselines would continue to be reported against so as to allow an 'easy to follow' audit trail of any subsequent modifications. We have also stated that at all times the sum of the route baselines will be equal to the national PR13 Final Determinations for the control period (i.e. overall cost neutral).

- *The process and principles for setting baselines and calculating REBS out(under)performance should be as transparent and simple as practicably possible, i.e. understandable to those who the mechanism intends to incentivise*

  We recognise the importance of this. Indeed in our PR13 submissions on the regulatory framework to-date, we have always stressed the need to minimise complexity. In consulting with industry ahead of setting the initial REBS baselines and proposing any subsequent adjustments, we would do so in a simple and transparent way, and would make available all relevant information to support our proposals.

- *Baselines must be set so that they are consistent with ORR's overall national-level PR13 determinations, i.e. they should deliver our determinations for England & Wales; and Scotland*

  We agree that this is an important principle and that the REBS baselines will be set in accordance with the national PR13 Final Determinations, for the control period as a whole.

  When setting the initial REBS baselines, we consider that flexibility to manage the profile of expenditure over the course of the control period for each of the routes is very important. This means that the route-level expenditure trajectories year-on-year could differ from those assumed in the PR13 Final Determinations although they would, in total, equal the overall national-level determinations for CP5.

  As stated above, we consider that when proposing any adjustments for particular routes, cost neutrality is key. We would need to demonstrate transparently to both the industry and ORR, that such adjustments would not alter the national PR13 Final Determinations, for the control period in total.

- *Baselines should clearly reconcile back to ORR's PR13 route-level efficiency assumptions*

  We note that in relation to disaggregation of price controls, your May 2012 publication on '*Setting the financial and incentive framework for Network Rail in CP5*' states that you are working on producing separate efficiency assumptions for England and Wales; and Scotland. We would, therefore, welcome further discussion with you on what the PR13 route-level efficiency assumptions would mean in practice.

  As discussed, above, our preferred approach is for ORR to allow Network Rail flexibility to set the REBS baselines and to propose any subsequent adjustments in accordance with the overall national PR13 Final Determinations. This would, therefore, allow flexibility in both the timing of efficient expenditure over the five years of the control period and across the different operating routes. We would take account of the national-level PR13 efficiency assumptions during this process.

- *As far as possible, there should be a single definition for outperformance in CP5 (and hence a common set of baselines), i.e. ORR's definition of outperformance for REBS should be consistent with definitions used elsewhere, e.g. in Network Rail's management incentives plan*

  We agree that, as far as possible, there should be a single definition of outperformance. It is important to be mindful, however, that the scope of REBS will not be the same as the scope for other measures of out(under)performance, which are intended for different purposes. For example, as you will be aware, we have proposed the inclusion of Financial Value Added (FVA) in the 2012-2015 Long Term Incentive Plan (which forms part of the Management Incentive Plan). FVA is used to quantify financial outperformance and includes elements such as interest and tax which we assume would not be included in REBS (on the basis that the scope of REBS, we consider, should only include those elements over which operators are able to exercise influence).

  Where the measures of out(under)performance are different, we understand the importance of being transparent with both ORR and industry. For those items that are included in both REBS and other measures of outperformance, we would provide a transparent reconciliation in our regulatory accounts.

- *It should be possible to clearly reconcile between information in Network Rail's regulatory accounts, our national level PR13 determinations, REBS route-level baselines and the annual calculations of route-level out(under)performance*

  We consider that this is possible. Assuming that Network Rail has the flexibility to set the initial REBS baselines for each route, in total they will reconcile back to the national-level PR13 determinations for CP5[1].

  We envisage that alongside our annual calculations of route-level out(under)performance, we would also present the initial REBS baselines for each

[1] In order for Network Rail to report against the national level PR13 determinations and the REBS baselines, we would require the supporting information from ORR used to calculate those baselines, including: volumes; pre / post efficient rates; and the specifics of any non-volume adjustments.

route (both ORR defined and adjusted), and that the inputs to the calculation would be consistent with those presented in our regulatory reporting (on the assumption that the timing of the calculations would be different from the publication of our regulatory accounts).

As we are also proposing that we have the flexibility to make adjustments to the initial REBS baselines during the control period, we would also need to demonstrate that in total, they reconcile back to the national level PR13 determinations for CP5. As proposed above, in subsequent reporting following any adjustments, the original baselines would be retained for complete transparency and would continue to be reported against.

- *Network Rail will be responsible for calculating and reporting performance – ORR expects Network Rail to be transparent in undertaking this activity, particularly where it is required to exercise discretion*

  We recognise the need for transparency in undertaking this activity, and we will provide supporting evidence with our calculations.

  We are mindful of some of the detailed discussions that have taken place during CP4 on how efficiency is defined and measured, particularly in relation to the treatment of deferrals and accelerations of renewals over the control period. Based on this experience, we would stress the importance of having agreement ahead of the beginning of CP5 on how efficiency will be defined and calculated for the purposes of measuring performance against the REBS baselines.

  In addition, based on our experience during CP4, it will be important to understand the extent to which REBS will interact with our performance on non-financial indicators, particularly train performance, but potentially also others.

  We would welcome further discussion on these areas at the earliest opportunity.

In addition to the principles set out, above, I am aware that at the 28 January 2013 stakeholder meeting, there was discussion around the need to have clearly defined principles governing the instances when we would be able to propose adjustments to the REBS baselines. We recognise the importance of this for operators' certainty, and would welcome further engagement and discussion on this area with ORR and operators.

An alternative proposal

While the proposed approach described, above, is our preferred method to setting the REBS baselines in CP5, an alternative approach could be to make annual adjustments to the expected outturn for a particular route and year, through an *ex-ante* process. The governance arrangements for proposing adjustments could follow the same arrangements as those outlined above for adjusting the baselines, whilst avoiding the need to change the initial baselines. The difference between this and the earlier alternative would be primarily presentational.

Summary

We would welcome the opportunity to discuss these proposals with you in more detail. We would like to reiterate our view that it is possible to achieve transparency whilst also having flexibility in meeting our output requirements year-on-year for each route, and ensuring that our business is carried out in the most efficient manner possible.

2. Scope of REBS

We note that ORR has not yet finalised specific items of income and expenditure that will be included in REBS, since this is closely related to efficiency reporting in CP5 on which you will consult as part of the Draft Determinations process in June 2013. We would like to take this opportunity, however, to highlight some key considerations relating to scope ahead of the consultation process later this year and would stress the importance of having a comprehensive list (for example, whether British Transport Police costs are included), in advance of the start of CP5, of what is within the scope of REBS.

We are encouraged that your December 2012 publication on aligning incentives recognises the benefits of including Network Rail's Schedule 4 and 8 costs in REBS. As we have stressed in previous submissions, notably our response to your May 2012 consultation on incentives, we believe the inclusion of Schedules 4 and 8 is essential if the REBS mechanism is to operate effectively as well as supporting the effective operation of Schedules 4 and 8 themselves. Having reviewed the responses to your May 2012 consultation and subsequent industry discussions, we are not aware of any opposition to the inclusion of Schedules 4 and 8 in REBS and would suggest, therefore, that this issue is concluded as soon as practicable.

We continue to believe that property and other revenue sources would be better suited to bespoke arrangements and that, therefore, REBS should not include any of Network Rail's revenue (other than the possible inclusion of the variable track access charges income which is discussed in the next section) .

3. Changes in traffic growth / demand

We consider that there needs to be a mechanism by which route efficiency calculations are able to take account of traffic growth. Absent such a mechanism we would be concerned that if traffic volumes increase against forecast volumes (which will be captured in the baselines) on a particular route, our variable costs for that route will increase. Without a mechanism to take account of this growth, the increase in variable costs would be interpreted as an 'underperformance' for which the relevant operators would be required to contribute 10%. This may dampen incentives for operators to work with us to grow traffic volumes above the target levels. Similarly, if traffic volumes were to decrease, our variable costs would also decrease which could be interpreted as an efficiency saving and result in a windfall gain to train operators.

Options for taking changes in traffic volumes into account in the REBS mechanism could be either the inclusion of income from variable track access charges associated with additional traffic or to make manual adjustments to reflect changing conditions.

Our preference would be to include the variable usage charge (VUC) and electrification asset usage charge income within the scope of REBS. We believe that this would allow a straightforward and automated calculation, removing the need to make more subjective assessments of the impact of traffic growth on efficiency. We assume that any volume incentive would not be included in the REBS calculations since this is not intended to relate to any incremental costs, but to provide a positive incentive to facilitate growth.

We would welcome further discussion on this with you and how it could work in practice.

Next steps

I hope this letter is helpful in setting out our position and how our proposal would work, in practice. Given its general importance, we will share this letter with operators by publishing it on our website.

I am sure that there are many aspects which would merit further discussion and we would welcome a meeting with your team to discuss, in particular, our proposal for setting the CP5 REBS baselines, and making any subsequent adjustments.

In the meantime if you have any questions, please do not hesitate to contact me or one of my team.

Yours sincerely,

pp Taylor

Paul Plummer