

Cathryn Ross,
Director, Railway Markets and Economics
Telephone: 0207 282 2025
E-mail: Cathryn.Ross@orr.gsi.gov.uk

17 December 2012



Paul Plummer,
Group Strategy Director
Network Rail
Kings Place
90 York Way
London
N1 9AG

Dear Paul,

Principles for setting expenditure baselines for the route-level efficiency benefit sharing (REBS) mechanism in CP5

In our Policy Management Meeting on 26 October 2012, you explained that Network Rail's preferred approach to setting route-level expenditure baselines for REBS in CP5 is that:

- ORR does not set the baselines but leaves Network Rail some discretion, for example, in its CP5 delivery plan;
- REBS baselines are not set as part of the final determination; and
- Network Rail has some discretion to re-set the baselines within the control period.

Although we will not consult on the methodology for assessing Network Rail's efficiency in CP5 until our draft determinations in June 2013, we agreed that I would write to you to explain the principles by which arrangements for setting REBS route-level baselines should adhere to in CP5. This letter should provide you with a better understanding of how we expect REBS to work, and also the possible constraints that this places on Network Rail's efficiency reporting in CP5.

The objective of REBS in CP5 is to strengthen the alignment of incentives between Network Rail and train operators (passenger and freight) in order to support greater co-operation to drive down industry costs. To support this objective, we will need to be able to establish the level of Network Rail's annual out(under)performance in order to assess the level of any REBS pay-outs. To be able to do this we need to be very clear about how the expenditure baselines for REBS will be agreed.

The rest of this letter explains our proposed principles, based on a REBS mechanism in CP5 that¹:

- operates at a route-level;
- provides train operators (passenger and freight) with capped upside (25% share) and downside (10% share) exposure to Network Rail's financial performance;
- has pay-outs which take into account any efficiencies achieved within alliances; and
- provides all train operators with an opt-out from the mechanism at the beginning of the control period.

Principles

An overarching requirement for measuring Network Rail's performance in CP5 is that we are able to determine whether Network Rail is out(under)performing our determined PR13 efficiency assumptions. Although this sounds straightforward, assessing Network Rail's financial performance in CP4 has been difficult, primarily due to operational issues such as its failure to deliver required outputs, the sustainability of its asset management policies and its asset information quality.

We acknowledge that Network Rail is making significant progress in addressing issues with its reporting of efficiencies², however, it will need to produce better quality information in CP5. We expect Network Rail's efficiency reporting to meet a required standard in CP5 and we will be setting out our requirements in our draft and final determinations.

In the context of our overarching requirement, we consider that the route-level baselines for REBS should adhere to the following principles:

- we are ultimately responsible for approving REBS expenditure baselines;
- baselines should be set before the start of the control period and take into account feedback from other industry participants³;
- 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;
- baselines must be set so that they are consistent with our overall national-level PR13

¹ Our decisions document is available at: <http://www.rail-reg.gov.uk/pr13/consultations/orr021.php>.

² The independent reporter, Arup, identified a number of important issues with Network Rail's reporting of efficiencies in 2010-11.

³ Our current thinking is that our PR13 draft determinations could act as the first industry consultation on route-level REBS baselines, with baselines agreed by the start of the control period.

determinations, i.e. they should deliver our determinations for England & Wales and Scotland;

- baselines should clearly reconcile back to our PR13 route-level efficiency assumptions;
- as far as possible, there should be a single definition for outperformance in CP5 (and hence a set of common baselines), i.e. our definition of outperformance for REBS should be consistent with definitions used elsewhere, e.g. in Network Rail's management incentives plan;
- it should be possible to clearly reconcile between information in Network Rail's regulatory accounts, our national PR13 determinations, REBS route-level baselines and the annual calculations of route-level out(under)performance; and
- Network Rail will be responsible for calculating and reporting performance⁴ – we expect Network Rail to be transparent in undertaking this activity, particularly where it is required to exercise discretion.

We understand why Network Rail is seeking some form of flexibility. It has put to us, and we understand, that without some flexibility there could be windfall gains and losses to train operators or Network Rail, and it could prevent changes which improve efficiency, e.g. through improved geographic differentiation of charges for national services or changes in route boundaries. Also, the impact of the asymmetric REBS design means that gains and losses to different routes/operators could result in a net cost to Network Rail, even when it achieves national efficiency targets. Network Rail considers that this needs to be reflected in how we treat risks in our PR13 regulatory framework and that an inability to flex the baselines, even at the beginning of the control period, would be a significant issue.

Given the principles above, our current view is that it would be difficult to develop a process which allows for material in-control period changes to REBS route-level baselines⁵, though there may be scope for flexibility that does not involve changes in baselines, and we are open to any proposal that you think will address our concerns. We are happy to discuss this further.

⁴ This is a change to the approach in CP4, as we are currently responsible for calculating and reporting EBSM pay-outs via our annual efficiency and finance assessment. In CP5 we want the industry to take the lead in determining pay-outs, within the framework we set out.

⁵ Although we do consider that changes to baselines would be accepted, where these are agreed between the affected parties (and do not affect parties outside of the agreement).

A copy of this letter will be placed on our website.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Cathryn Ross', with a stylized flourish at the end.

Cathryn Ross