



OFFICE OF RAIL REGULATION

Aligning incentives to improve efficiency

Update and further consultation

May 2012



Contents

Executive summary	4
Purpose of this document	4
Re-cap on REBS	4
REBS and alliancing	5
Exposing operators to changes in Network Rail's costs at a periodic review	6
Consultation and next steps	7
1. Introduction	8
Background	8
Purpose of this document	9
Structure of this document	9
Responding to this consultation	9
2. Update on route-level efficiency benefit sharing (REBS)	10
Introduction	10
Recap on REBS	10
Key considerations for establishing REBS	11
Our role in the REBS mechanism once implemented in CP5	11
Financial implications	12
Consultation responses	13
Our current position on REBS	14
3. REBS and alliancing	16
Introduction	16
Context	16
REBS and alliancing	17
Considerations / issues	19
Consultation questions and next steps	23
4. Exposing operators to changes in Network Rail's costs at a periodic review	24
Introduction	24
Context	24
Objectives	25
Lessons from other sectors	25
Developing a mechanism for exposure to changes in costs at a periodic review	26

Carry-forward of REBS out(under)performance	30
Summary	30
Consultation and next steps	31
Annex A: Summary of responses to our May 2011 and December 2011 consultations	32
Responses to May 2011 consultation questions	32
Responses to December 2011 consultation questions	33

Executive summary

Purpose of this document

1. As part of our on-going work on the 2013 periodic review (PR13), we have consulted on options for strengthening the alignment of the incentives on Network Rail and train operators (both passenger and freight operators) to work together to improve cost efficiency¹. We have considered two types of approach:

- (a) developing a route-level efficiency benefit sharing (REBS) mechanism, building on the mechanism that we implemented in PR08; and
- (b) exposing train operators to changes in Network Rail's costs at future periodic reviews.

2. The purpose of this document is to:

- (a) provide an update on our position regarding the implementation of REBS for CP5;
- (a) consult on the options for how the REBS mechanism will interact with alliancing arrangements entered into by Network Rail and train operators; and
- (b) consult further on our proposal to expose operators to Network Rail's costs at future periodic reviews;

Re-cap on REBS

3. We see the introduction of REBS in CP5 as a means of strengthening and aligning the incentives between Network Rail and train operators to work together to improve cost efficiency. In our December 2011 incentives consultation we set out our specific proposal for REBS. The key features of this are that:

- (a) train operators would be rewarded for working with Network Rail to identify and implement initiatives to improve Network Rail's efficiency over and above what we set out for CP5 as part of our PR13 determination, i.e. they would share in Network Rail's outperformance. Train operators would also bear some of the risk of Network Rail not achieving the efficiencies we assumed in our determination for CP5, i.e. they would share in Network Rail's underperformance;
- (b) the mechanism would be implemented at a Network Rail operating route level;
- (c) the mechanism would be 'asymmetric', which exposes train operators to both upside and downside of Network Rail's performance: operators share 25% of outperformance and 10% of underperformance on support, operating, maintenance and renewals expenditure;

¹ PR13 will establish Network Rail's outputs and access charges for control period 5 (CP5) which is expected to run from 1 April 2014 to 31 March 2019. PR13 also involves establishing the wider regulatory financial and incentive framework for CP5 that applies to Network Rail and train operators.

(c) operator exposure to both upside and downside is capped – at 10% of Network Rail's outperformance or underperformance compared to the efficient expenditure baseline we assume for CP5;

(d) each individual train operators' share of REBS would be based on their relative share of variable usage charges paid on the route (following the global sharing and capping explained above);

(e) membership is compulsory, except where alliance arrangements are in place or where operators fall below a 'cut-off' (or 'de minimis' threshold); and

(f) the mechanism covers operating, maintenance and renewals expenditure as well as some elements of Network Rail's revenue.

4. We see REBS as a comprehensive and straightforward 'default option', in the absence of alliancing arrangements, to strengthen/align incentives to improve Network Rail's efficiency. We also believe that REBS should be recognised as a mechanism that is value enhancing to both Network Rail and to train operators, i.e. it should help Network Rail achieve higher efficiencies than it would in the absence of operator involvement, and provide train operators with a share of the financial rewards of outperformance that they have contributed towards. Whilst exposure to underperformance is part of the REBS design, our expectation is that there is more likely to be outperformance, due in part to the asymmetric design, but also because we expect to establish efficiencies for CP5 that are challenging but achievable as part of a balanced package of PR13 determinations.

5. Having consulted on REBS in detail in December 2011 and engaged with a wide range of stakeholders, we are minded to continue with the approach set out in our December 2011 consultation, subject to a number of minor changes and clarifying a number of issues following consultation.

6. We will not, however, confirm our approach on REBS until we have clarified our position on the interaction of the mechanism with alliances.

REBS and alliancing

7. Network Rail has recently announced that it plans to form 'alliances' with train operators with the aim of delivering a better service for passengers and freight users at lower overall cost. We support the concept of alliances and welcome their potential to deliver benefits, including rail users and taxpayers.

8. In our recent policy statement on alliancing we said that one of the issues we needed to conclude in respect of alliancing is how efficiency savings arising from alliancing would be shared and accounted for under REBS. The way in which financial out(under)performance is treated could have an effect on the size of any pay-outs under the REBS mechanism. This is because under alliancing Network Rail and its alliance partner intend to share the out(under)performance arising from the alliance.

9. There are two alternative approaches for calculating the overall out(under)performance from REBS, where there is an alliance in place:

(a) **Option A (REBS excluding alliances):** REBS pay-outs are calculated, before considering performance within the alliance, i.e. Network Rail's share of the alliance partner out(under)performance of the alliance baseline is not factored into the calculation of REBS pay-outs and it is calculated on the basis of Network Rail's costs associated with operating the rail network.

(b) **Option B (REBS including alliances):** REBS pay-outs are calculated by including out(under)performance achieved within the alliance, i.e. Network Rail's share of an alliance partner's out(under)performance is recognised in the calculation of REBS pay-outs to other operators. Network

Rail prefers this option as it believes that this approach provides incentives to support the alliance to 'do the right thing' for the railway as a whole, whereas under option A, Network Rail see a risk that managers within the alliance are incentivised to account alliance profits to the alliance partner and alliance losses to Network Rail.

10. The two alternative approaches raise a number of issues:

(a) **Scope of REBS.** Under option A the focus of REBS on delivering improvements in infrastructure efficiency is retained, whereas under option B the scope of REBS is extended to include the effects of the alliance partner's (a train operator) financial performance.

(b) **Assurance.** Under option A we do not need to impose any specific information or assurance requirements on the alliance, although we will need to ensure that Network Rail's regulatory accounts continue to accurately account for infrastructure related costs even if incurred by the alliance partner. Under option B we will need to have sufficient assurance on the causes of out(under)performance by the alliance, given that one of our roles is to sanction payments under REBS.

(c) **Governance.** Option B exposes secondary operators to financial risk from the relative underperformance of the alliance partner, which we do not directly regulate. Secondary operators may consider that they have a limited ability to reduce the non-infrastructure related costs of the alliance and that they are being put 'on-risk' for costs that they cannot influence. Our expectation is that in order to help identify and implement initiatives to improve infrastructure efficiency, established industry processes/forums will be utilised for operators to engage with Network Rail, e.g. route planning groups. However, under the alliances, if option B is adopted, we consider that there will need to be equivalent forums so that secondary operators can engage with both Network Rail and the alliance partner to discuss efficiency initiatives.

11. We are seeking consultees' views on the two alternative options to help us make a decision on the most appropriate option to adopt.

Exposing operators to changes in Network Rail's costs at a periodic review

12. Under the current industry arrangements, franchised passenger train operators have very little exposure to Network Rail's costs arising from a periodic review, due to the 'Schedule 9' provisions in franchise agreements that largely hold them harmless to changes in Network Rail's costs at a periodic review. This is in contrast to the position for freight operators who are exposed to changes in the level of the charges they may pay.

13. In order to strengthen and align the incentives for cost efficiency improvement, and to encourage greater train operator involvement in the periodic review process, we are proposing to implement a mechanism to expose train operators to changes in Network Rail's costs arising from future periodic reviews. Train operators would share some of the differences between the baselines and our final periodic review determination. This mechanism would complement REBS.

14. We highlighted this issue in our May 2011 and December 2011 consultations but did not discuss in any detail. This consultation discusses the issues in more detail. However, we will be consulting further on this mechanism before we draw conclusions, given the importance of getting the design of the mechanism right to ensure the appropriate balance of risk and reward for train operators.

15. This mechanism would create an incentive for operators to help 'set' the efficient baseline. We consider that this would lead to the emergence of much more commercial arrangements between Network Rail and its train operator customers.

16. In terms of how periodic review exposure would function in practice, we envisage that the mechanism would first be implemented to take effect from the start of CP6, so should influence behaviour in the run up to and during the 2018 periodic review (PR18). As with REBS, we would expect the mechanism to work at the Network Rail route level.

17. The consultation discusses the definition of the expenditure baseline – which is the basis against which train operators will share a proportion of the difference between this and the periodic review determination. We see the baseline as the relevant cost base for the following control period that is ‘frozen’ at the end of the preceding control period, reflecting the prevailing level of demand, outputs, asset policies and efficiencies at that point. Given the baseline, we discuss three broad approaches for the mechanism:

- (a) **Efficiency only.** Only changes to the expenditure baseline (covering support, operating, maintenance and renewals expenditure, and some aspects of property income) arising from revised asset policies and efficiency fall under the mechanism.
- (b) **All changes in expenditure.** All changes to the expenditure baseline apply, and train operators share or bear a proportion of these, which includes demand and outputs as well as efficiency and asset policies.
- (c) **Wider Network Rail costs.** The mechanism would include changes in Network Rail’s wider costs, e.g. financing costs as well as the expenditure items identified above. We consider that exposing operators to all changes in the level of Network Rail’s cost base, even with a mechanism that includes sharing rules and exposure caps, may transfer an inappropriate amount of risk to the operators.

18. In our discussions with industry, there has been some support for an additional mechanism that is ‘backwards looking’ and gives train operators a longer-term share of past efficiencies. Such an incentive mechanism could work by factoring into train operators’ track access charges (for the next control period) a proportion of out(under)performance achieved under REBS in the previous control period. This would provide train operators with a longer-term incentive to maximise efficiencies on their routes. We appreciate that a backwards looking mechanism could help strengthen incentives on train operators to help Network Rail reduce costs and we are interested to understand consultees views on this.

Consultation and next steps

19. We welcome responses to any aspect of this consultation and we are raising some specific questions. The consultation closes on 28 June 2012.

20. Following this consultation:

- (a) **REBS and alliancing.** We intend to set out our conclusions on REBS and on how it interacts with alliancing in September 2012.
- (b) **Exposure to changes in costs at a periodic review.** Our intention is to publish a further, shorter consultation on detailed issues relating to the periodic review exposure mechanism in September 2012 and to conclude on the design of the mechanism in December 2012.

1. Introduction

Background

1.1 The 2013 periodic review (PR13) will establish Network Rail's outputs and access charges for control period 5 (CP5), which is expected to run from 1 April 2014 to 31 March 2019. PR13 will also establish the wider regulatory framework (i.e. the financial and incentive framework) for CP5 that applies to Network Rail and train operators (both passenger and freight operators).

1.1 As part of our on-going work on PR13, we consulted in May 2011 and December 2011 on options for strengthening the alignment of the incentives on Network Rail and train operators, to work together to improve cost efficiency². In these consultations, we considered two types of approach for improving the alignment of incentives. These were:

- (a) developing a route-level efficiency benefit sharing (REBS) mechanism, building on the mechanism that we implemented in the 2008 periodic review (PR08) for the current control period by disaggregating it to the route level and introducing an upside and downside; and
- (b) exposing train operators to changes in Network Rail's costs at future periodic reviews – in order to normalise the customer/supplier relationship.

1.2 In parallel with our consultations and associated discussions with the industry and the two governments for England and Wales, and Scotland, there has been significant progress in the development of alliances between Network Rail and third parties with in particular, the creation of a deep alliance on the Wessex operating route that has just started. The development of alliances across Network Rail's operating routes has implications for our proposals for REBS in CP5. In our recent policy statement on alliancing³, we explained that we would consider how efficiency savings arising from alliancing would be shared and accounted for under REBS.

1.3 Exposure of train operators to changes in Network Rail's costs represents a significant change to the industry architecture. It is important that this is discussed thoroughly and that the design of the mechanism properly balances risk and reward. As such, this consultation is a further stage in the development of this mechanism, and we plan for further consultation before we reach conclusions.

1.4 A further consideration is how, for the remainder of control period 4 (CP4), the existing national efficiency benefit sharing mechanism (EBSM) will be applied in the context of alliances. Network Rail recently wrote to us to propose an approach to EBSM and alliancing. We are reviewing Network Rail's proposal and intend to consult on this by the end of May 2012.

² Our May 2011 consultation is available at: <http://www.rail-reg.gov.uk/pr13/consultations/orr013.php>, and our December 2011 incentives consultation is available at: <http://www.rail-reg.gov.uk/pr13/consultations/orr020.php>.

³ Our policy statement is available at: <http://www.rail-reg.gov.uk/upload/pdf/alliancing-policy-statement-march-2012.pdf>.

Purpose of this document

1.5 The purpose of this document is to:

- (a) provide an update on our position regarding the implementation of REBS for CP5;
- (b) consult on the options for how the REBS mechanism will interact with alliancing arrangements entered into by Network Rail and train operators; and
- (c) consult on our proposal to expose train operators to Network Rail's costs at future periodic reviews;

Structure of this document

1.6 The rest of this document is structured as follows:

- (a) Chapter 2: update on our proposals for route-level efficiency benefit sharing (REBS).
- (b) Chapter 3: REBS and alliancing.
- (c) Chapter 4: exposing train operators to changes in Network Rail's costs at a periodic review.

1.7 We have also included a summary of responses to our May 2011 and December 2011 consultations in annex A, where these relate to aligning Network Rail and train operator incentives.

Responding to this consultation

1.8 We welcome responses to any of aspect of this consultation but we also raise a number of specific questions. Please send your responses in electronic (or if not possible, in hard-copy format) by 28 June 2012 to:

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London WC2B 4AN
Email: jonathan.hulme@orr.gsi.gov.uk
Tel: 020 7282 2131

1.9 Please note, when sending documents to us in electronic format that will be published on our website, we would prefer that you email us your correspondence in Microsoft Word format. This is so that we are able to apply web standards to content on our website. If you do email us a PDF document, where possible please:

- (a) create it from the electronic Microsoft Word file (preferably using Adobe Acrobat), as opposed to an image scan; and
- (b) ensure that the PDF's security method is set to no security in the document properties.

1.10 If you send a written response, you should indicate clearly if you wish all or part of your response to remain confidential to ORR. Otherwise, we would expect to make it available on our website and potentially to quote from it. Where your response is made in confidence please can you provide a statement summarising it, excluding the confidential information, which can be treated as a non-confidential response. We may also publish the names of respondents in future documents or on our website, unless you indicate that you wish your name to be withheld.

2. Update on route-level efficiency benefit sharing (REBS)

Introduction

2.1 This chapter provides an update on route-level efficiency benefit sharing (REBS) for CP5. It includes:

- (a) a recap of the proposed REBS mechanism we set out in our December 2011 consultation;
- (b) a summary of consultation responses; and
- (c) our current position.

Recap on REBS

2.2 We initially consulted on REBS in May 2011. In that consultation we proposed a number of important revisions to the existing EBSM so that the mechanism would work at the Network Rail operating route level and allow train operators to share in both the benefits and costs of Network Rail's performance – an 'upside' and 'downside'. We also suggested that there may be a role for bespoke arrangements which covered enhancement expenditure, where this expenditure was not covered by REBS (we raised the question of whether small enhancements should be covered by REBS).

2.3 In our December 2011 incentives consultation, following consideration of the responses to the May 2011 consultation and further discussion with the industry, we set out our specific proposal for REBS for CP5. The key features of our proposal were that:

- (a) the mechanism would be implemented at a Network Rail operating route level;
- (b) train operators would be rewarded for working with Network Rail to identify and implement initiatives to improve Network Rail's efficiency over and above what we set out for CP5 as part of our PR13 determination, i.e. they would share in Network Rail's outperformance. Train operators would also bear some of the risk of Network Rail not achieving the efficiencies we assumed in our determination for CP5, i.e. they would share in Network Rail's underperformance;
- (c) the mechanism would be 'asymmetric' in how it exposes train operators to both upside and downside of Network Rail's performance: operators would share 25% of outperformance and 10% of underperformance compared to the efficiency assumptions set out in our determination;
- (d) train operator exposure to both upside and downside would be capped – at 10% of Network Rail's outperformance or underperformance compared to the efficient expenditure baseline we assume for CP5⁴;

⁴ The upside cap translates to 2.5% of Network Rail's efficient expenditure baseline (based on train operators sharing in 25% of Network Rail's outperformance with a cap of 10%, i.e. $25\% * 10\% = 2.5\%$ of Network Rail's baseline expenditure). The downside

- (e) each individual train operators' share of REBS would be based on their relative share of variable usage charges paid on the route (following the global sharing and capping explained above);
- (f) membership would be compulsory, except where alliance arrangements are in place or where operators fall below a 'cut-off' (or 'de minimis' threshold); and
- (g) the mechanism would cover operating, maintenance and renewals expenditure as well as some elements of Network Rail's revenue, which is the same as EBSM currently in place.

Key considerations for establishing REBS

2.4 In setting out our proposals for REBS, we have been guided by the following considerations:

- (a) REBS should be seen as a comprehensive and straightforward 'default option', in absence of alliancing arrangements, to strengthen/align incentives to improve Network Rail's efficiency;
- (b) we believe that REBS should be recognised as a mechanism that is value enhancing to both Network Rail and to train operators, i.e. it should help Network Rail achieve higher efficiencies than it would in the absence of operator involvement, and provide train operators with a share of the financial rewards of outperformance that they have contributed towards;
- (c) whilst exposure to underperformance is part of the REBS design, in order to strengthen incentives, our expectation is that there is more likely to be outperformance due in part to the asymmetric design but also because we expect to establish efficiencies for CP5 that are challenging but achievable as part of a balanced package of PR13 determinations; and
- (d) the design should be as simple as possible.

Our role in the REBS mechanism once implemented in CP5

2.5 In PR13, our role is to develop, and establish, a challenging but achievable ('outperformable') efficiency target which Network Rail, with the help of train operators, can aim to exceed. Once the efficiency assumptions have been set, our role during CP5 for REBS (as it is for the current control period under EBSM) would be to:

- (a) assess annually Network Rail's performance against our PR13 assumptions;
- (b) approve REBS payments, if applicable, which will be subject to the test (as in the current control period) of there being demonstrable engagement by train operators and Network Rail to identify and implement initiatives to improve efficiency; and
- (c) monitor the success of the revised mechanism. Following the implementation of REBS in CP5, we intend to conduct a review of the effectiveness of REBS after two years of operation and, if necessary, make any changes, following consultation.

2.6 In March this year, we wrote to stakeholders⁵, to provide an update on EBSM. This letter explained that our assessment of Network Rail's efficiency and financial performance for 2010-11 highlighted a number of

cap of 1% is based on train operators sharing in 10% of Network Rail's underperformance with a cap of 10%, i.e. $10\% * 10\% = 1\%$ of Network Rail's determined/baseline expenditure.

⁵ This is available at: <http://www.rail-reg.gov.uk/upload/pdf/benefit-sharing-mechanism-220312.pdf>

concerns with Network Rail's reporting of efficiencies⁶. Whilst we recognised that Network Rail has made improvements to its efficiency reporting, we highlighted a number of areas which remained a concern. As a result, we have decided to conclude on the 2010-11 EBSM payments as part of our annual efficiency and finance assessment of Network Rail in July 2012.

2.7 As part of PR13, we are currently considering the measurement of efficiency in CP5, which will have a direct impact on REBS. We intend to ensure that the quality of information and explanations that Network Rail provides, as part of the overall approach to measuring Network Rail's efficiency performance, is agreed and set out publicly well ahead of the start of CP5. We intend to provide further details on this work in a further consultation in September 2012 and discuss it at an industry workshop in October 2012.

Financial implications

2.8 The potential risks and rewards faced by train operators is an important consideration in designing an appropriate mechanism to incentivise train operators and Network Rail to work together to improve cost efficiencies. Our proposal for REBS takes this into consideration with an asymmetric design which puts the emphasis on outperformance/upside and caps which limit operator exposure.

2.9 We have considered the financial implications of REBS in three main ways, with the key aim being to better understand the potential impacts on passenger and freight train operators so that we can establish the parameters to achieve the most appropriate balance of risk and reward:

(a) **High-level assessment.** We considered the potential risks and rewards of REBS at an overall industry level. We estimate that passenger train operators would be exposed to a maximum downside of about £32m per year across Great Britain⁷. This is less than 0.5% of total passenger operator turnover and approximately 10% of passenger operator pre-tax profit. The maximum upside under the same assumptions would be approximately £80m per annum across Great Britain, which equates to some 1% of total train operator turnover and would increase passenger operator pre-tax profits by approximately 25%. For freight operators, the maximum downside is about £8m per annum and maximum upside is about £20m per annum. Note that all of the values above are sector totals, before any allocation to individual train operators, which is based on their relative share of variable usage charges.

(b) **Statistical modelling.** In annex B of our December 2011 incentives consultation, we summarised the results of our illustrative statistical analysis which sought to estimate the impact of our REBS proposal on train operator and Network Rail finances. This analysis considered five stylised operators on indicative operating routes, e.g. an operator serving a single route or a large national operator, and simulated a large number of scenarios of out(under)performance across operating routes. For Network Rail, our analysis suggested that, taking account of variations between routes, REBS would marginally reduce Network Rail's downside risk. Depending on how the baseline is set, it may also increase Network Rail's expected profit through train operators' actions to reduce costs. Additionally, the mechanism results in an increase in train operators' risk. Under our proposal, the additional risk from REBS is small (for example, prior to taking into account the benefits of efficiency gains, our analysis suggests it accounts for less than 10% of train operators' expected profit) and, given that the mechanism is asymmetric, the expected pay-

⁶ Our annual efficiency and finance assessment of Network Rail for 2010-11 is available at http://www.rail-reg.gov.uk/upload/pdf/nr_annual_assessment_2010-11.pdf.

⁷ This assumes Network Rail spends approximately £4bn per year on operating, maintenance and renewals (OM&R) expenditure that falls into the REBS mechanism. It is calculated as 10% sharing of Network Rail underperformance capped at 10% on OMR of £4bn per annum (i.e. £4bn * 10% * 10% = £40m) factored by passenger operators' share of variable usage charges (80%). For freight operators, the calculation is the same except that the freight operator share of variable usage charges is 20%.

out is positive. If the additional risk from REBS is small relative to the portfolio of risks that the train operators already bear, as it has little correlation with those risks, then the potential cost of train operators' downside risk (from REBS) may be negligible.

(c) **KPMG's modelling.** Jointly with ATOC, we commissioned KPMG to assess the impacts of our proposed REBS mechanism on the profitability of train operators, and in turn the potential impact on franchise bids. This work involved modelling of the financial impacts of REBS for operators on three different operating routes, across three control periods, and holding discussions with owning groups to understand their views on the likely impact of the mechanism. KPMG's analysis suggested that, based on the modelling assumptions, the REBS mechanism would be likely to have a small positive impact on train operator profits of up to 2%, although this could vary by route depending on the size of the operating route cost base, relative to train operator costs and turnover. Discussions with owning groups highlighted some concerns with REBS. These focused on the accuracy of Network Rail's efficiency reporting and hence on our confidence in the level of efficiency actually achieved; the weakening of incentives towards the end of the control period; and the possible negative impact on bid margins. These uncertainties led owning groups to suggest that REBS would not result in an increase in bid margins. There was strong support for caps on downside exposure, without which owner groups suggested that they would price the risk of REBS into their bids negatively.

Consultation responses

2.10 In our May 2011 and December 2011 consultations, we asked consultees for their views on our proposals for REBS. The questions that we posed covered the principles of the mechanism as well as consideration of practical issues associated with implementing the mechanism.

2.11 There was widespread, but not unequivocal, support for REBS. Supporters of the principles of REBS included DfT, ATOC, and the Rail Freight Group. They all considered that the mechanism would provide incentives for train operators and Network Rail to work together to improve Network Rail's cost efficiency. Similarly, many train operators agreed with the aims of REBS but had questions relating to the design, particularly exposure to downside risk. Although Transport Scotland's feedback on REBS was not as positive as other stakeholders, it was broadly supportive of any new measures that support a more integrated approach to the management and delivery of rail services and help to improve efficiency.

2.12 A number of consultees suggested that REBS could act as the default sharing mechanism with operators also able to enter into bespoke / alliancing arrangements with Network Rail. For example, ATOC said that there would be additional benefits brought about by bespoke deals and that REBS should be the basis upon which to promote efficiency and share the benefits across the industry. Another suggestion from Network Rail was that REBS should include efficiencies in Schedule 4 and 8 costs as this would otherwise create a perverse incentive for operators, i.e. operators could encourage Network Rail to reduce costs at the expense of performance, yet they would be sheltered from worsening performance under Schedules 4 and 8, but would benefit from increased efficiency via REBS pay-outs.

2.13 Respondents did highlight some issues about the structure and practical implications of a route-level mechanism, with exposure to upside and downside risk, which included:

- (a) the difficulty of measuring Network Rail's efficiency, with freight operators highlighting that the existing EBSM has yet to pay out due to issues with Network Rail's reporting of efficiencies;
- (b) as a result of Schedule 9 arrangements within franchise agreements, there could be a situation where although secondary operators on a route were exposed to REBS, the lead operator was not;

- (c) exposure to downside risk in the mechanism, which train operators including Go-Ahead considered would dilute Network Rail's incentives to outperform, whilst adding to franchising costs;
- (d) the potential for there to be an excessive administrative burden for companies that operate across a number of operating routes; and
- (e) the ability to influence Network Rail, which some respondents thought would be particularly difficult for small operators.

2.14 Network Rail made it clear in its consultation response that it did not agree with the asymmetric nature of our proposal, i.e. that Network Rail would pay out 25% of outperformance but only receive a 10% contribution from operators in a case of underperformance. In addition to its consultation response, Network Rail recently provided us with an analysis which sought to quantify the average pay-out that would be made by the company as a result of the asymmetric design. Using a common statistical modelling technique (Monte Carlo analysis), Network Rail's analysis concluded that under certain assumptions⁸, when excluding the expected benefits from REBS on route performance (i.e. outperformance should be more likely than underperformance with operator involvement), the average total pay-out from Network Rail to operators could range from £40m to £100m over CP5.

2.15 We will take into account the issue of asymmetry when establishing our overall package of determination for Network Rail in CP5, and will also consider the likely impact of gains from REBS due to the impact of operator effort, which we expect would offset some of the potential costs to Network Rail.

2.16 In annex A, we have included a more detailed review of responses to the questions we asked in relation to efficiency sharing in our May 2011 and December 2011 consultations.

Our current position on REBS

2.17 Having consulted on REBS in detail in December 2011 and engaged with a wide range of stakeholders, we are minded to continue with the approach set out in our December 2011 incentives consultation.

2.18 One exception to this is the inclusion of small scale enhancement projects in REBS, which we had initially raised as an option. We are minded to exclude these projects from REBS as we consider that they are more suitable for bespoke/alliancing arrangements.

2.19 We will not, however, confirm our approach on REBS until we have clarified our position on the interaction of the mechanism with alliances. The recent development of alliances between Network Rail and train operators, specifically on the Wessex operating route, has raised some significant issues for our REBS proposal. We discuss the implications of alliances on our proposed CP5 REBS mechanism in the next section. We have set out our current view here to inform stakeholders and support responses to our consultation on the interaction on REBS and alliances.

2.20 In addition to the interaction of REBS and alliances, there are also three other issues that we are still considering. These are:

⁸ Network Rail's analysis assumed that each route would on average meet its efficiency targets. Additionally, although Network Rail explored the possibility that performance on one route was correlated with performance on another, this analysis was not incorporated into the identified range of possible pay-outs under REBS. In its analysis, Network Rail chose to exclude the likely positive effects on route-level performance that REBS is expected to deliver, i.e. lead to a higher likelihood of Network Rail outperforming efficiency targets than underperforming on each route. Network Rail excluded this incentive effect in order to isolate the implications of the asymmetry of REBS.

(a) the level of the caps under REBS for freight operators, given their ability to bear risk, including whether:

- (i) there should be a different level of capping for freight operators; and
- (ii) varying the cap could be considered discriminatory.

(b) the de minimis level / threshold below which, operators are exempt from, or can opt-out of, REBS, including whether:

- (i) there should be a de minimis level/threshold within REBS;
- (ii) a de minimis level should lead to a complete exemption or simply the opportunity for a train operator to opt-out of the mechanism; and
- (iii) any threshold should apply by route or at the national level.

(c) the specific expenditure and revenue items that will be included within the mechanism, including:

- (i) whether to include Schedule 4 and 8 costs;
- (ii) which categories of Network Rail's revenue, if any, should be included.

We intend to discuss these issues with the industry in parallel with this consultation.

2.21 Although we are minded to implement REBS as set out, subject to the further work on the interaction with alliancing, and the points raised in the previous paragraph, we would be keen to receive any further views from respondents with any issues that they have not raised before, which they believe we should take into account before we finalise our approach on REBS. We intend to set out our conclusions on REBS in September 2012.

3. REBS and alliancing

Introduction

3.1 This chapter discusses the interaction of REBS and alliancing. It includes:

- (a) context on alliances;
- (b) explanation of how REBS could interact with alliances;
- (c) illustration of the potential financial implications of the different approaches to REBS and alliancing;
and
- (d) consultation questions and next steps.

Context

3.2 Network Rail has recently announced that it plans to form ‘alliances’ with train operators with the aim of delivering a better service for passengers and freight users at lower overall cost⁹. An ‘alliance’ is an agreement between Network Rail and a train operator to work more closely together and share the benefits of doing so, within the framework of their existing individual accountabilities and responsibilities. The scope of an alliance can range from an agreement for a one-off project through to more comprehensive and longer-term working arrangements. Alliance arrangements do not currently involve the creation of new legal entities such as formal joint ventures.

3.3 We support the concept of alliances and welcome their potential to deliver benefits, not only for the parties involved but also for rail users and taxpayers. Of course, we will need to ensure that adequate safeguards exist for those outside of an alliance, and alliance parties will need to deal with safety, legal, regulatory and commercial issues – and transparency will be important to demonstrate how the concerns of others are addressed¹⁰.

3.4 In its recent command paper¹¹, DfT explained that it welcomed the direction of the McNulty Rail Value for Money (RVfM) Study recommendations and considered greater alignment of incentives for efficiency between Network Rail and train operators to be necessary to drive down costs for rail industry. DfT is committed to exploring the full menu of options for promoting greater alignment and considers that decentralisation of certain functions within Network Rail and the formation of alliances with train operators is essential to make Network Rail more accountable to its train operator customers.

⁹ Network Rail's draft policy statement on alliancing is available at: <http://www.networkrail.co.uk/alliances.aspx>

¹⁰ Our policy statement on alliancing is available at: <http://www.rail-reg.gov.uk/upload/pdf/alliancing-policy-statement-march-2012.pdf>.

¹¹ DfT's command paper is available at: <http://www.dft.gov.uk/publications/reforming-our-railways/>

3.5 Transport Scotland is considering, mainly as part of the development of the successor to the current ScotRail franchise, what elements of industry reform it wishes to promote – such as arrangements to provide greater alignment between Network Rail and train operators. In this regard, it has welcomed the recent alliance agreement between Network Rail and ScotRail.

REBS and alliancing

3.6 REBS and alliances have a shared goal: to incentivise Network Rail and train operators to work together to drive efficiency savings and performance, above a level which could be achieved by Network Rail or its train operator partner in the alliance independently. In the absence of alliances, the outperformance achieved on an operating route is likely to be less than under an alliance, i.e. where operators and Network Rail are working closely together to identify and drive out efficiency savings, although it is not possible to put firm numbers on this and there will remain a risk that the alliance underperforms. Nonetheless, it is, therefore, clearly beneficial to incentivise everyone who uses the route to support the alliance.

3.7 We need to confirm how our proposal for REBS should treat efficiencies and financial outperformance that are achieved by an alliance. The way in which we treat this financial outperformance and efficiencies (i.e. include or exclude them) could, under certain scenarios, have an effect on the size of any pay-outs under the REBS mechanism.

3.8 As background, it is helpful to set out an example of how outperformance within an alliance is likely to be measured. For example, at the start of the alliance, Network Rail and the alliance partner (we refer to the train operator(s) within an alliance as the alliance partner(s)) would determine their baseline costs (separate baseline for Network Rail's costs and for alliance partner costs), which reflect the costs that they would have incurred, had the alliance not been in place. Once these baselines have been agreed by the alliance, only savings that exceed this baseline will be classed as outperformance and shared between Network Rail and the alliance partner. At the end of each financial year, the efficiency savings that have been achieved by the alliance, measured against the baseline, would be shared between the alliance partner and Network Rail, e.g. 50:50.

3.9 With this process in mind, the rest of this section looks at two different options for calculating the overall out(under)performance from REBS, where there is an alliance in place, and the implications/issues of each approach. The two options are:

(a) **Option A (REBS excluding alliances):** REBS pay-outs are calculated, before considering performance within the alliance, i.e. Network Rail's share of the alliance partner out(under)performance of the alliance baseline is not factored into the calculation of REBS pay-outs and it is calculated on the basis of Network Rail's costs associated with operating the rail network, as set out in our December 2011 consultation and summarised in Chapter 2.

(b) **Option B (REBS including alliances):** REBS pay-outs are calculated by including out(under)performance achieved within the alliance, i.e. Network Rail's share of an alliance partner's out(under)performance is recognised in the calculation of REBS pay-outs to other operators. On an operating route with an alliance, this option would work as follows:

(i) the baseline of performance/efficiency for the alliance cost base is agreed between the alliance partner and Network Rail;

(ii) Network Rail and the alliance partner share (e.g. 50:50) in financial rewards of out(under)performance, compared to the alliance baseline;

(iii) Network Rail's share of the alliance out(under)performance is added to the total 'pool' of out(under)performance which would be considered for purpose of REBS; and

(iv) the REBS pay-out to operators would then be calculated based on Network Rail's out(under)performance, including the Network Rail's share of out(under)performance achieved within the alliance.

3.10 Option B is Network Rail's preferred approach as it considers that this approach will:

- (a) incentivise secondary operators on the route to work with an alliance to improve efficiencies;
- (b) not introduce perverse incentives for an alliance to 'make' and book 'profits' and 'losses' to either the alliance partner or Network Rail;
- (c) protect minority operators from 'where' an alliance decides to make efficiencies; and
- (d) align all parties behind the same objectives.

Financial implications of REBS calculation approach

3.11 The two calculation options for REBS will lead to different levels of REBS pay-outs. Table 3.1 highlights this issue by setting out five scenarios of out(under)performance. In our example, both Network Rail and the alliance partner outperform in four scenarios and underperform in one scenario.

Table 3.1: Illustrative example of REBS calculation options

Scenario	Outperformance (£m)			Network Rail pay-out from alliance (£m) ¹²	REBS payments to operators (£m)	
	Alliance partner	Network Rail	Alliance total		A) REBS exc. alliances	B) REBS inc. alliances
1	100	50	150	75	12.5	18.75
2	50	100	150	75	25	18.75
3	75	75	150	75	18.75	18.75
4	(100)	50	(50)	(25)	12.5	(2.5)
5	50	(100)	(50)	(25)	(10)	(2.5)

3.12 In the first scenario, outperformance on the side of the alliance partner is greater than on Network Rail's. Under option A (REBS excluding alliances), train operators would receive a REBS pay-out totalling £12.5m, i.e. 25% of Network Rail's outperformance. Under option B (REBS including alliances), the REBS pay-out would be higher, £18.75m, i.e. 25% of Network Rail's outperformance, including its share from the alliance. In this case, secondary operators would benefit not only from infrastructure efficiencies but also those achieved by the alliance partner. Scenario 2 presents a case where the balance of outperformance is reversed (i.e. greater outperformance by Network Rail compared to the alliance partner), in which option A (REBS excluding alliances) would lead to the greater REBS pay-out. When outperformance by the alliance partner and Network Rail is equal, the two options give the same REBS pay-out, as shown in scenario 3.

3.13 An alternative case is presented in scenario 4, whereby Network Rail's outperformance is more than offset by the alliance partner's underperformance. In this example, option A (REBS excluding alliances)

¹² Here, we assume that Network Rail and the alliance partner share the out(under)performance within the alliance equally, i.e. 50:50 share.

would result in a positive REBS pay-out of £12.5m. However, under option B (REBS including alliances) train operators would be required to compensate Network Rail £2.5m for underperformance of the route efficiency target. The final scenario considers a situation where Network Rail underperforms and the alliance partner outperforms. In this scenario, the REBS pay-out that train operators would have to pay to Network Rail would be reduced under option B (REBS including alliances) from £10m to £2.5m, and hence other operators benefit from the inclusion of alliance efficiencies in the REBS calculation.

3.14 In understanding the savings achieved by the alliance, it is important to note that although a cost saving might accrue to one party within the alliance, that saving may actually be the result of positive management actions/efforts by the other party. As an example, in a situation where the alliance partner took on responsibility for one of Network Rail's support activities (where the alliance partner would incur a lower cost than Network Rail), knowing that it would receive a share of the benefits via the alliance sharing arrangements, this would show as an increase in costs for the alliance partner and a decrease in costs for Network Rail. In this example, looking at just one side of the alliance could give an incorrect view of the source of the savings. Under an alliance arrangement, it may therefore be difficult to attribute alliance efficiencies to the efforts of the alliance partner separately to efforts of Network Rail.

3.15 We recognise that alliances may only cover a proportion of Network Rail's costs, e.g. operating and maintenance costs, whereas REBS would cover a wider range of costs (and some revenues). We would take account of this in calculating pay-outs, if option B (alliance including REBS) is adopted.

3.16 It is also worth highlighting that the method for calculating REBS pay-outs does not affect the pay-outs under the alliance due to the alliance partner. The alliance partner would always receive its share of the alliance out(under)performance, as agreed with Network Rail. The choice between the two calculation methods only has an impact for Network Rail and for secondary operators on the route. Also, under either option for calculating REBS pay-outs, our working assumption is that the alliance partner would still receive pay-outs under REBS, where applicable, as per the REBS sharing arrangements (i.e. based on variable usage charges). It would then be up to Network Rail to decide whether to reflect the impact of the alliance partner's REBS pay-outs (the alliance partner would receive its share of alliance outperformance, as well as any REBS pay-out), in the sharing arrangements for the alliance.

Considerations / issues

3.17 In choosing the most appropriate method for calculating REBS pay-outs under an alliance, we consider there to be four main issues which need be resolved. These are:

- (a) the focus on infrastructure efficiencies;
- (b) transparency/assurance of alliance financial information;
- (c) governance arrangements and involvement of secondary operators; and
- (d) legal considerations.

Focus on infrastructure efficiencies

3.18 In developing both the existing EBSM and REBS, the focus has been to incentivise train operators and Network Rail to work together to deliver infrastructure efficiencies; improving the efficiency of train services is outside the scope of these mechanisms as originally envisaged.

3.19 With option A (REBS excluding alliances), the focus of the mechanism on achieving infrastructure savings is maintained. REBS pay-outs for secondary operators are not impacted by the

out(under)performance of an alliance partner, against an alliance baseline. Under this option, only those efficiencies achieved by Network Rail on its operating, maintenance and renewals expenditure (as well as some areas of income) will be used in the calculation for REBS.

3.20 In choosing option B (REBS including alliances), REBS pay-outs are no longer dependent on just Network Rail's infrastructure cost savings/efficiencies. Under this option, where an alliance is in place, the pay-outs due to secondary operators would be dependent, to some extent, on the performance of the alliance partner. As a result, secondary operators are directly exposed to the financial performance of the alliance partner. This could mean that the secondary operators may not benefit if, say, train operator/alliance partner losses outweighed infrastructure outperformance. Conversely, secondary operators could benefit if the opposite situation occurred.

3.21 In essence, including the impact of the alliance partner's financial performance within the calculation of REBS pay-outs (option B) is a change to the scope of the initial REBS proposal, since it would extend the mechanism to encompass the train operator/alliance partner costs as well as infrastructure management costs.

Transparency/assurance of alliance financials

3.22 If the alliance partner's financial performance is to be included in the REBS calculation, it would be essential that we have visibility of both sides of the alliance baseline and alliance outturn costs so that we can be sure that the reported efficiencies which contribute to REBS are accurate.

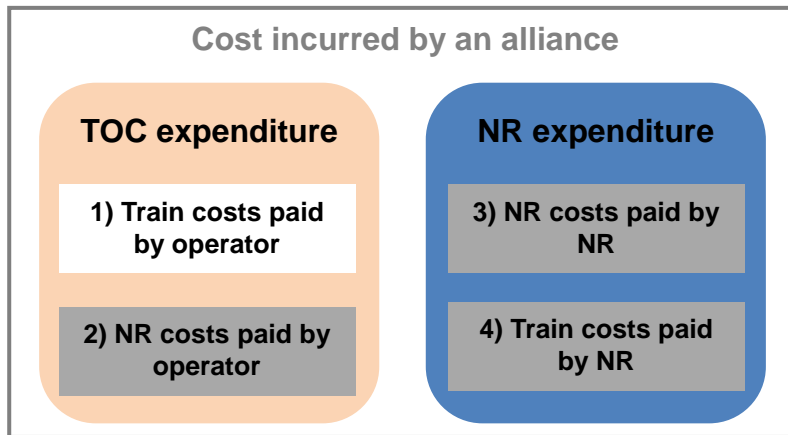
3.23 We require Network Rail to report on its expenditure and income for its network operations, principally through annual regulatory accounts. The regulatory accounts capture Network Rail's efficiency savings and form the basis of our annual calculation for possible pay-outs under the existing EBSM. In the absence of an alliance, we would expect to continue with the same approach for calculating pay-outs under the revised REBS mechanism (subject to the further work noted in chapter 2 to review and improve the measurement of Network Rail's efficiency). As part of our work on disaggregation, from 2011-12, Network Rail will publish in its regulatory accounts, route-level information on key aspects of Network Rail's income and expenditure. This will support the implementation of REBS.

3.24 The regulatory accounts, which are produced in line with our regulatory accounting guidelines, provide transparency of Network Rail's performance, and as they are independently audited they help provide assurance that we are accurately calculating pay-outs under EBSM (or in the future REBS), where these are due.

3.25 Our regulatory responsibilities do not cover the audit of train operators' financial performance, or the economic regulation of train operators. We do, however, have powers under section 80 Railways Act 1993 to require that any licence holder (including train operators) provide us with information that we consider necessary for the purpose of facilitating the performance of any of our functions.

3.26 Even in the absence of REBS, Network Rail would need to, as a minimum, include information on the financial gains (or losses) resulting from alliances in its regulatory accounts. Such information would need to be presented clearly. Figure 3.1 shows the different types of costs that would be incurred within an alliance, i.e. those that could contribute to out(under)performance within the alliance. Network Rail's regulatory accounts could be extended to cover the expenditure highlighted in grey in figure 3.1. Although details of reporting arrangements for alliances still need to be agreed, we consider that the level of detail required will depend on the form of the alliance, i.e. whether it is a one-off project-based alliance or a deep alliance.

Figure 3.1: Alliance expenditure types



3.27 It is important to highlight that although regulatory accounts can help to identify where a cost has been incurred, e.g. by the alliance partner or Network Rail, it is more difficult to determine the side of the alliance that generated a particular cost saving.

3.28 Under option A (REBS excluding alliances), we would not necessarily need assurance of the alliance baseline for the purpose of REBS, as alliance efficiencies would be excluded from the calculation of REBS pay-outs. We would, however, want to understand the performance of an alliance for other reasons, e.g. for efficiency reporting.

3.29 Adopting option A (REBS excluding alliances) could, however, incentivise Network Rail and the alliance partner to 'make' and 'book' outperformance on the alliance partner side and underperformance to Network Rail in order to reduce REBS pay-outs to other operators, when there is alliance outperformance (but obtain contributions from secondary operators when there is underperformance). Under option A, Network Rail argues, secondary operators would be exposed to the impact of decisions by the alliance partners on allocations of costs and revenues that could be arbitrary and not well-understood. At a network-wide level, Network Rail argues that this approach could also disincentivise alliances from 'doing the right thing'. We consider, however, that by including visibility of alliance transactions in Network Rail's regulatory accounts, this issue should diminish. The visibility of alliance transactions in the regulatory accounts would give third parties, e.g. secondary operators, the opportunity to review and, if necessary, raise any concerns with us about the efficiencies which have been reported within the alliance as we assess the REBS pay-out each year. The independent audit of information contained in the regulatory accounts should further reduce the ability to 'game' the mechanism.

3.30 If option B (REBS including alliances) were adopted, in order to accurately calculate REBS pay-outs we would need sufficient information to build a clear picture of how, and where, any savings (inside and outside of the alliance) have been achieved. As we have discussed above, any additional information relating to alliances that is contained within Network Rail's regulatory accounts would, as with the rest of the accounts, be independently audited. An audit opinion would provide assurance that the reported transactions between Network Rail and the alliance partner are reflective of actual income and expenditure. The regulatory accounts will not, however, contain information on train operator costs that have been incurred by the train operator on the route in question.

3.31 The lack of visibility, to those outside the alliance, of train operator costs paid by the train operator is important: under option B (REBS including alliances), REBS pay-outs would be directly related to the baseline for these costs, and to the costs that were actually incurred by the alliance partner. If we were to adopt option B (REBS including alliances), then we would need to rely on Network Rail's assessment and acceptance of the alliance baseline. In this case, we would effectively treat the alliance arrangement as

another commercial contract that Network Rail would enter into, e.g. a benefit share arrangement with an engineering contractor.

3.32 Transparency of alliance activities is clearly important. Although there is a significant amount of publicly available information on Network Rail, there is much less for potential alliance partners, i.e. train operators. We would be interested to understand how consultees view the different levels of transparency between the two parties that would be involved in an alliance.

Governance arrangements and secondary operators

3.33 In any alliancing scenario, appropriate governance arrangements are required so that the interests of parties outside of the alliance can be protected.

Transparency

3.34 In our policy statement on alliancing, we considered how Network Rail could provide visibility of any bilateral agreements, and make clear the impact of these, to third parties. For example, by explaining alliance principles or features in the network statement, or by providing a reference in it to where individual arrangements are available. Further details of this can be found in our policy statement.

3.35 As we have discussed above, additional financial information on alliances could be included in Network Rail's regulatory accounts, which would provide a level of assurance that the reporting of financial flows into, and out of, Network Rail are accurate and transparent.

3.36 Under option B (REBS including alliances), the calculation of REBS pay-outs is dependent on the baseline set at the start of the alliance agreement. From a governance perspective, Network Rail should be able to justify that the agreed alliance baseline is fair for both parties within the alliance and that it reflects the costs that would have been incurred in absence of the alliance. We do not anticipate having a significant role in assuring the alliance baseline. Under option A (REBS excluding alliances), the role of the alliance baseline is less of an issue, for REBS, as the out(under)performance is excluded from the REBS calculation of efficiency.

Involvement of secondary operators

3.37 Having already highlighted the potential benefits of alliances, we agree that secondary operators should be incentivised to support the concept of the alliance and work with the alliance to reduce costs.

3.38 Including the performance of the alliance within the calculation of REBS pay-outs (option B), would create this incentive as a successful alliance could result in higher REBS pay-outs to secondary operators. Option B does, however, expose secondary operators to financial risk from the relative underperformance of the alliance partner, which we do not directly regulate. Secondary operators may consider that they have a limited ability to reduce the non-infrastructure related costs of the alliance and that they are being put 'on-risk' for costs that they cannot influence.

3.39 Under the existing EBSM in CP4, the expectation has been that the industry uses established processes/forums for operators to engage with Network Rail, e.g. route planning groups. However, under an alliance, for REBS to be effective, there will need to be equivalent forums so that secondary operators can engage, not just with Network Rail, but also with the alliance partner(s) to discuss efficiency initiatives.

3.40 It is clearly important that alliances treat all operators fairly when negotiating and agreeing alliances, and in operating the alliance. The issue of how secondary operators are treated on a route with an alliance is a wider consideration than its interaction with REBS. The issue does, however, become more important under option B (REBS including alliances) as decisions made by the alliance could have a direct impact on secondary operators' finances through the effect on REBS pay-outs.

3.41 It is important to note that adopting option A (REBS excluding alliances) does not completely remove the link between an alliance's actions and REBS pay-outs. Train operators, outside of an alliance, will still be exposed to decisions that an alliance makes around where to focus its efforts on achieving efficiencies. For example, if an alliance chooses to invest £10m of infrastructure costs to create savings of £20m in train operation costs (i.e. alliance partner costs), then under option A (REBS excluding alliances), this could be reported as underperformance under REBS.

Legal considerations

3.42 Obviously, whichever approach for REBS is adopted would have to be consistent with relevant EU legislation, including EU Directive/2001/14/EC. In particular, we have to take account of the provisions of the Railways Infrastructure (Access and Management) Regulations 2005 which require, amongst other things, that track access charges are non-discriminatory and transparent.

Consultation questions and next steps

3.43 In this chapter we have considered two options for calculating the overall out(under)performance from REBS: option A: REBS excluding alliances, and option B: REBS including alliances. We have highlighted the advantages and disadvantages of each option. Following this consultation, we will decide which option should be adopted for alliances. As part of this we will be assessing compliance of the options with relevant EU legislation.

3.44 We are very keen to receive comments on both approaches and on any other aspect of the interaction of REBS and alliancing. More specifically, we are interested in responses to the following questions:

- (a) Which approach to calculating REBS pay-outs do you consider to be most appropriate in relation to alliancing?
- (b) If you prefer option B, are you content that we do not carry out any audit/reporting of the financial performance of the alliance partner (in the same way as we do for Network Rail through the regulatory accounts)?
- (c) Are there any issues that we have not raised which you consider are significant and which we need to address before the approach to REBS and alliancing is finalised?

Next steps

3.45 Our consultation period for our approach to REBS and alliancing lasts for eight weeks and will close on 28 June 2012. Following this date, we will consider all responses and intend to set out our conclusions on this issue in September 2012.

4. Exposing operators to changes in Network Rail's costs at a periodic review

Introduction

4.1 This chapter discusses the exposure of train operators to changes in Network Rail's costs at future periodic reviews. It:

- (a) provides context;
- (b) sets out the objectives;
- (c) discusses experience in other sectors;
- (d) sets out practical issues with designing and implementing a mechanism; and
- (e) sets out the consultation questions.

Context

4.2 Building upon our proposals for REBS, in our May 2011 and December 2011 consultations we also outlined the possibility of introducing a new mechanism that would lead to Network Rail sharing operating, maintenance and renewal cost risk (and potentially risk relative to some Network Rail revenue items), route-by-route, with train operators from control period 6 (CP6) onwards.

4.3 Under the current industry arrangements, franchised passenger train operators have very little exposure to Network Rail's costs arising from a periodic review, due to the 'Schedule 9' provisions in franchise agreements that largely hold them harmless to changes in Network Rail's costs at a periodic review. This is in contrast to the position for open access and freight operators who are exposed to changes in the level of the variable charge. As a consequence, freight operators have typically engaged extensively in periodic reviews – both with Network Rail and with us. Passenger train operator involvement has been much more limited in the periodic review process, though we recognise that they are keen to see lower infrastructure costs.

4.4 In order to address this, and to encourage greater train operator involvement in the future, we are now proposing a mechanism to expose train operators to changes in Network Rail's costs arising from future periodic reviews, starting in CP6 (i.e. following engagement in the 2018 periodic review). For such a mechanism to have an effect, DfT, Transport Scotland, and other franchising authorities would need to relax provisions that hold train operators harmless to changes in Network Rail's costs at a periodic review.

4.5 This mechanism would need to take effect during our next periodic review process (PR18), which will start during CP5, and we therefore want to set out our proposals well ahead of this. Also, by setting out our proposals now, we hope that this will give franchising authorities the information necessary to consider this mechanism in any new franchise agreements.

4.6 This mechanism complements REBS and should strengthen the incentive on operators to engage with Network Rail and with us to help improve efficiency.

4.7 The responses to the December 2011 consultation on this issue were generally mixed. A number of stakeholders, including Network Rail, stated that they were supportive in principle while requesting further details of how the mechanism would work in practice. Other respondents, notably some train operators, expressed concern around the ability of operators to effectively influence Network Rail costs and suggested that this would increase the risk profile of new franchises.

Objectives

4.8 In considering the potential benefits of exposing train operators to variances in Network Rail's cost base arising from a periodic review, we consider it may be helpful to start by outlining the key differences between the proposed REBS mechanism and the proposed periodic review exposure mechanism.

4.9 In essence, REBS should create an incentive for operators to work with Network Rail to 'outperform' the baseline set by us at the time of the periodic review. If Network Rail is able to outperform the determination, assisted by the operators, then both parties will enjoy the short term benefits provided by the REBS mechanism.

4.10 The key difference with a mechanism that exposes train operators to Network Rail's costs at the periodic review is that this creates an incentive for train operators to help 'set' the efficient baseline. The incentive properties within REBS tend to function 'ex post' after we have set the determination. This means that in isolation, REBS could create an incentive for operators to argue for a lenient efficiency baseline, to build in 'fat' at the periodic review on the expectation of easier gains in the following control period. In contrast, if operators were also exposed to variances in Network Rail's costs at a periodic review it would create a powerful 'ex ante' incentive for operators to engage in the process of regulation, and with Network Rail directly, and hence minimise their exposure to cost increases.

4.11 We consider that this would lead to the emergence of much more commercial arrangements between Network Rail and its train operator customers. Specifically, greater engagement between the parties is likely to uncover the sorts of mutually beneficial agreements and trade-offs that emerge as a matter of course in the commercial negotiations that would normally take place between companies at different points in the supply chain.

Lessons from other sectors

4.12 There are some parallels with our proposal to the experience observed in a number of other regulated sectors in the UK. In the case of air travel from South East airports, air navigation services, electricity supply and gas supply, vertical separation within the industry means that the regulated company is not generally responsible for the relationship with the final customer¹³. Instead, the regulated company in each case acts as a supplier and is able to pass its costs through in the charges it levies to its customers (e.g. airlines and energy suppliers).

4.13 Faced with an increase in cost, the customer of the regulated company can either absorb this increase and reduce its own margins or it can pass the increase through in the price it charges to end-users and risk losing some demand for the product (depending on the flexibility it has in terms of end-user

¹³ This is in contrast to, for example, the water sector where vertical integration of the industry means that the regulated company is responsible for the relationship with the final customer.

prices). Neither of these options is likely to be palatable for a commercial organisation and as a consequence these companies seek to control costs and minimise the impact on their own businesses. In the case of costs imposed by a regulated company, this can mean working with the regulator to understand the regulated company's cost drivers, and to provide evidence that will support the case for a reduction in costs.

4.14 Over time, airlines and energy suppliers have become increasingly active in the process of regulation even though they themselves are not subject to price cap regulation. Evidently, the impact on their own cost base is sufficiently significant for them to dedicate resources and effort in an attempt to manage this cost.

4.15 The situation whereby the customers of the regulated company engage with the company, and the regulator, at the time of the price review exists only to a limited extent in the railway industry (with the notable exception of freight). Whilst we would not necessarily expect the arrangements that apply in the rail industry to mirror those that apply elsewhere, we consider that it can be informative to observe the approach taken in other sectors and to draw lessons where this may be appropriate.

4.16 A notable example of engagement in the regulatory process by train operators took place during CP3, when traction electricity costs rose: a cost train operators were fully exposed too. On this issue, train operators engaged forcefully with us, and Network Rail, to develop a new procurement approach and on-train metering.

Developing a mechanism for exposure to changes in costs at a periodic review

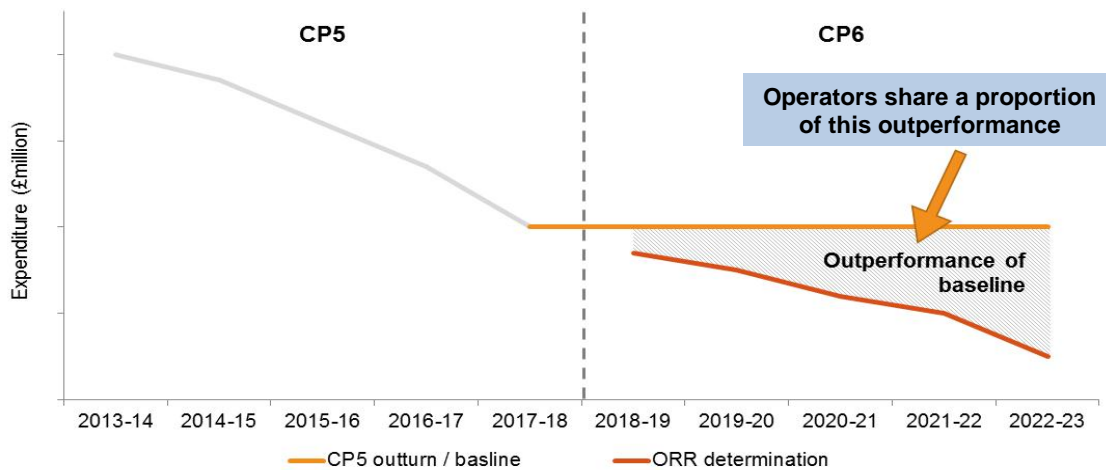
4.17 In terms of how periodic review exposure would function in practice, we envisage that the mechanism would first be implemented to take effect from the start of CP6, so should influence behaviour in the run up to and during the 2018 periodic review (PR18). This means that as well as expecting operators to work closely with Network Rail to identify opportunities for outperformance during CP5 under REBS, we would expect train operators to begin preparing for CP6 by familiarising themselves with the regulatory regime, developing their understanding of Network Rail's cost base and engaging on these issues at PR18. As a result, train operators would share some of the difference between the baseline and our final determination for CP6.

4.18 In terms of scope, we propose that the mechanism would operate on a similar basis to REBS in that it would function route-by-route and would cover operating, maintenance and renewals expenditure, as well as property income.

Defining a baseline

4.19 A crucial aspect of any mechanism of this kind would be the establishment of a baseline against which any pay-out would be calculated. Figure 4.1 sets out a stylised example of how the pay-out mechanism might function in practice.

Figure 4.1: Calculating pay-outs for periodic review exposure mechanism



4.20 An important consideration is, therefore, how we intend to define the baseline – which is the basis against which train operators will share a proportion of the difference between this and the periodic review determination. We see the baseline as the relevant cost base for the following control period that is ‘frozen’ at the end of the preceding control period, reflecting the prevailing level of demand, outputs, asset policies and efficiencies at that point. Given the baseline, we see three broad approaches for the scope of the mechanism:

- (a) **Efficiency only.** Only changes to the expenditure baseline (covering support, operating, maintenance and renewals expenditure, and some aspects of property income) arising from revised asset policies and efficiency would fall under the mechanism. This provides a focus on efficiency, but in practice it means that the mechanism is effectively ‘upside only’ as we are unlikely to make a determination with a lower level of efficiency than Network Rail proposes.
- (b) **All changes in expenditure.** All changes to the expenditure baseline (defined as in the ‘efficiency only’ approach) would apply, and train operators would share or bear a proportion of these, which includes demand and outputs as well as efficiency and asset policies. This approach has a wider scope: it recognises that train operators do have the ability to influence outputs and demand, but this is less controllable and hence, all other things equal, introduces more risk in the mechanism that we need to be aware of when we establish the sharing and capping parameters.
- (c) **Wider Network Rail costs.** The mechanism would include changes in Network Rail’s wider costs, e.g. financing costs, as well as the expenditure items identified above. This would expose train operators to changes in all of Network Rail’s costs, which reflects a more conventional customer/supplier arrangement, and what is in place in other sectors (e.g. the airline/airport relationship). However, the ability of train operators to influence Network Rail’s wider costs (e.g. financing costs) is limited and, moreover, the ability to pass changes in costs on to their customers is limited. For this reason, we consider that exposing operators to all changes in the level of Network Rail’s cost base, even with a mechanism that includes sharing rules and exposure caps, may transfer an inappropriate amount of risk to the operators.

4.21 A balance needs to be struck between incentivising operators to help manage costs that they have some ability to control while ensuring that any new regulatory mechanism does not unduly transfer risk to operators. More generally, we consider that it will be important for any new regulatory mechanism to increase overall value for money for the sector and that it should not transfer revenues to operators unless they have contributed towards lowering industry costs.

4.22 Before reaching conclusions on the categories of costs that should be included in the mechanism, and level of exposure to changes in these costs, we consider that further work needs to be done to identify

more fully those areas that operators may have scope to influence and their ability to absorb and manage additional risk.

4.23 We would welcome the views of consultees on this issue.

4.24 As with REBS, we consider that the mechanism should be subject to sharing rules and caps. We consider that the mechanism should have more detailed sharing rules which would have the benefit of sharpening incentives at the margin. For example, we could introduce 'dead-bands' into the mechanism whereby at low levels of outperformance (i.e. savings above the baseline), train operators would share in a small proportion of any outperformance, and pay-outs under the mechanism would be relatively low. However, as the level of outperformance increased, train operators would receive a high percentage share of these additional savings. This 'incremental' approach to rewarding train operators would help to reflect the increasing difficulty of finding further efficiency savings above the baseline. The downside with this type of approach is that it would add a further layer of complexity to the process.

4.25 For the purposes of this initial proposal, we have presented a worked example of the periodic review exposure mechanism in table 4.1 under different scenarios of out(under)performance, based on one possible set of rules. Although we have explored the idea of 'dead-bands' in our example, it is important to note that these are purely illustrative and we will be doing further work and analysis over the coming months to develop the appropriate sharing rules and caps. Our example uses the following assumptions:

(a) in an upside scenario, train operators share:

(i) for the first 5% reduction in the baseline (over the control period) as determined by us in the periodic review, a 2% share of any reduction;

(ii) for the next 5% reduction in the baseline (over the control period) as determined by us in the periodic review, i.e. between 5% and 10%, a share of 5% of this additional reduction; and

(iii) for any further reduction against the baseline, i.e. above 10% (over the control period) as determined by us in the periodic review, a share of 25% of this additional reduction.

(b) in a downside scenario, train operators share:

(i) for the first 5% increase above the baseline (over the control period) as determined by us in the periodic review, a 2% share of any increase; and

(ii) for any further increases above the baseline, i.e. above 5% (over the control period) as determined by us in the periodic review, a share of 5% of this additional increase.

(c) for the purpose of simplifying the example, risks and rewards are not constrained by caps (although we expect caps to be introduced into this mechanism to limit train operator risk); and

(d) train operators' share by route will be determined by their proportion of variable usage charges (as with REBS).

Table 4.1: Stylised example of periodic review exposure proposal

Scenario	Outperformance of baseline	Resulting determination	Total savings above baseline (£m)	Operators' incremental share (£m)	Total operator share (£m)
A	5%	1,491	78.5	1.6	1.6
B	10%	1,413	157.0	3.9	5.5
C	15%	1,334	235.5	19.6	25.1
D	0%	1,570	0	0	0
E	-5%	1,648	-78.5	-1.6	-1.6
F	-10%	1,727	-157.0	-3.9	-5.5
G	-15%	1,805	-235.5	-3.9	-9.4

4.26 In the example in table 4.1, the route baseline is £1,570m over CP6, as shown by scenario D.

4.27 In scenarios A to C, our final determination is lower than the initial route cost baseline, i.e. there is outperformance. Based on our illustrative sharing rules, for the first 5% reduction in our determination below the baseline (scenario A), train operators receive a 2% share of the savings: as a result, train operators on that route would receive pay-outs of £1.6m over the next control period. If our determination is 10% lower than the baseline (scenario B), then train operators still receive a 2% share of the first 5% reduction but also receive a higher share of the additional outperformance (train operators share in 5% of this additional saving). In scenario B, train operators would receive pay-outs totalling £5.5m. In scenario C, train operators would receive a further £19.6m over the next control period as a reward for a significantly lower cost determination. In scenario C, total pay-outs to train operators under the periodic review exposure mechanism would be £25.1m, as a result of helping to achieve a total reduction in control period costs of £235.5m. This is approximately a 10% share of the total outperformance. The remaining percentage of the variance would be passed through to funders in the form of lower access charges and network grant.

4.28 In our example, train operators receive a relatively small pay-out when outperformance is low but as outperformance becomes more significant, train operators stand to gain a larger share of the savings.

4.29 In scenarios E to G, our determination is actually adjusted upwards, i.e. there is underperformance. At lower levels of 'underperformance', train operators share in a relatively small percentage of the cost increases (2% share up to 5% underperformance), e.g. £1.6m for 5% underperformance. Although at low levels of out(under)performance (+/- 10%), the mechanism is symmetric, we consider that the mechanism should be asymmetric at higher levels of performance, i.e. an upside share higher than the downside, to reflect train operators' ability to bear risk. We reflect this view in our example above by setting the train operator share of underperformance which is greater than 5% of the initial baseline at 5%. In scenario C, where underperformance equals 15%, train operators only pay out £9.4m (compared to outperformance of 15% where they would receive £25.1m).

4.30 At this stage in the development of the proposal, we consider the sharing rules set out above to be illustrative pending consultation and further assessment of the impact on operators at individual route level. We consider that the sharing rules and the caps will need to be calibrated in such a way that they provide sufficient incentives on operators to engage in the process while ensuring that an appropriate level of risk is transferred from funders to operators.

4.31 We expect that pay-outs due under the periodic review exposure mechanism will be in the form of adjustments to train operators track access charges.

4.32 More generally, we consider that this proposal raises a number of detailed and practical implementation issues that will need to be worked through before we can conclude on the design of this mechanism.

Carry-forward of REBS out(under)performance

4.33 In our discussions with industry, there has been some support for an additional mechanism that is 'backwards looking' and gives train operators a longer-term share of past efficiencies. Such an incentive mechanism could work by factoring into train operators' track access charges (for the next control period) a proportion of out(under)performance achieved in the previous control period. This would provide train operators with a longer-term incentive to maximise efficiencies on their routes.

4.34 For example, where additional route outperformance could be achieved in the latter years of the control period, it would provide a stronger incentive for train operators to engage with Network Rail to realise these gains, as operators would see the benefit of higher REBS pay-outs (within the year that the savings were made), as well as a reduction in track access charges in the next control period. Conversely, where Network Rail has underperformed against our efficiency assumptions, train operators would face higher charges in the next control period.

4.35 We appreciate that an additional backwards looking mechanism could help strengthen incentives on train operators to help Network Rail reduce costs, however, we consider that this may lead to a 'double pay-out' to train operators whereby they receive a pay-out under REBS within the control and also receive a future financial benefit via reduced track access charges in the next control period. We are interested to understand consultees' views on such a mechanism.

Summary

4.36 Following our earlier consultations in May 2011 and December 2011 on the importance of incentives we remain committed to developing the regulatory regime by taking steps to improve the alignment of incentives of the stakeholders within the industry.

4.37 Whilst we believe that REBS will be beneficial in encouraging operators to work with Network Rail to seek outperformance opportunities within the control period, we also see considerable merit in encouraging operators to engage with the process between regulatory periods i.e. at the time we undertake periodic reviews. Such engagement has become a normal feature of other regulated industries. The evidence from these sectors would tend to suggest that train operating companies who are commercially focused and deal with Network Rail on a daily basis would be well placed to bring their experience to the table at the time of periodic price reviews.

4.38 We consider that an approach such as the one set out above would go some way to addressing the finding from the RVfM study that incentives between Network Rail and train operators are currently ineffective or misaligned and that this has led to barriers to improving efficiency. However, we are aware that this proposal requires further development over the coming months to ensure that:

- (a) the balance of risk and incentives is set at an appropriate level;

(b) issues around the establishment of a baseline and the scope of the mechanism are well understood; and

(c) the detail of the scheme and the implications of different approaches are developed together with affected parties.

4.39 We propose to work with Network Rail, train operators, funders and other interested stakeholders to consider these issues in greater detail.

Consultation and next steps

4.40 We would welcome the views of stakeholders on all of the issues discussed in this chapter, and in particular your views on:

(a) the approach to defining the baseline under the periodic review exposure mechanism;

(b) the balance of risk and reward under the periodic review exposure mechanism; and

(c) a 'carry-forward' of REBS benefits/costs into the next control period

4.41 Following this consultation, our intention is to publish a further, shorter consultation on detailed issues relating to the periodic review exposure mechanism in September 2012 and to conclude on the design of the mechanism in December 2012. During this process, we will continue to meet and discuss the issues with train operators, governments and other stakeholders.

Annex A: Summary of responses to our May 2011 and December 2011 consultations

In our May 2011 and December 2011 consultations, we asked a number of questions relating to the alignment of incentives to improve efficiency. We have summarised consultees' responses in this annex.

Responses to May 2011 consultation questions

Q14 *Do you agree that we should include a regional efficiency benefit sharing mechanism calculated at the Network Rail route level? Are there further issues about how a regional efficiency benefit sharing mechanism should be introduced which you want to highlight?*

The majority of respondents supported the principle of moving to a route-level efficiency benefit sharing (REBS) mechanism, which included the Department for Transport, ATOC, and freight and passenger train operators such as Freightliner, DB Schenker, First Group, Northern and Directly Operated Railways. Those in support of our proposal considered that REBS would improve engagement between operators and Network Rail, help achieve local efficiencies, and improve the links between cause and effect of train operator involvement in efficiencies.

Notwithstanding this support, responses highlighted some key concerns with the working of the mechanism. For example, most operators did not agree that they should face any downside risk, and that if this were to be the case, they would expect caps on their level of exposure. Other concerns included: the ability for Network Rail to accurately measure and report efficiency savings; the potential complexity and additional administration of a formulaic mechanism; the compulsory involvement in REBS – some responses suggested there should be an opt-out where bespoke arrangements were in place; and the difficulty of balancing route-level and network-level priorities.

Consultees who had reservations about our proposal included Network Rail, East Midlands Trains and West Coast Trains. These stakeholders stated a preference for bespoke / alliance arrangements and considered that these agreements would be more beneficial as they could be developed to suit the relationship in question, rather than through a 'one-size-fits-all' mechanism.

Q15 *What are your views on exposing franchised passenger train operators to changes in Network Rail's costs at a periodic review?*

Responses to this proposal were mixed. Those stakeholders that were in favour of this proposal suggested that it would encourage more engagement with Network Rail, and the periodic review process, however, Network Rail suggested that operators should only be exposed to the costs that they are able to influence. The majority of responses, whether supportive or unsupportive, expected this type of incentive to increase train operators' financial risks and that this would be reflected in higher franchise risk premia, possibly negating any financial benefits of the mechanism which would otherwise flow back to funders.

Q16 *Do you believe that Network Rail should share in train operator revenue and/or costs? Are there further issues about introducing a revenue/cost sharing mechanism which you would highlight?*

There was no support for our proposal for Network Rail to share in train operator revenue and/or costs, with most responses focusing on revenue sharing, rather than cost sharing.

Freight operators including Freightliner and DB Schenker, argued that as margins in the sector are low, this mechanism would increase prices for customers. Additionally, with freight companies

operating in a competitive private sector, these operators are already exposed to some of Network Rail's costs.

Passenger operators were also opposed to this proposal and highlighted the following concerns:

- revenue sharing may incentivise Network Rail to favour high revenue, long distance operators over urban and regional operators;
- taking in account the size and scale of train operators, it would be difficult to implement revenue sharing that was material to Network Rail; and
- Network Rail's ability to influence train operator costs and revenues is limited.

Q17 We would welcome your views on possible bespoke arrangements for enhancement efficiency benefit sharing and whether there is a need for additional measures to increase the contestability of expenditure?

There was overwhelming support from passenger operators and Network Rail for bespoke arrangements. East Midlands Trains suggested that bespoke arrangements could help to provide it with incentives to undertake activities, leading to cost savings for Network Rail, which would not currently lead to a benefit for the operator. First Group also welcomed the opportunity to be rewarded for greater co-operation to reduce costs under bespoke / alliancing agreements.

Freight and open access operators, however, appeared more cautious and although there was a consensus that bespoke arrangements could help to reduce costs, respondents wanted to protect the network from a reduction in outputs/capability. For example, the Rail Freight Group wanted protection of freight capability.

ATOC highlighted the need to balance incentives between existing incentive mechanisms and bespoke arrangements between operators and Network Rail. ATOC considered both to be important but expected that bespoke arrangements would increase over time.

Responses to December 2011 consultation questions

Q4.1 What are your views on our proposed principles for efficiency sharing arrangements between Network Rail and train operators? To what extent do you think they will improve the incentives on train operators to work with Network Rail to reduce its costs?

In our December 2011 incentives consultation, we set out a number of principles which we considered should be the basis for the REBS mechanism design. Responses to this question tended to be broader than a review of the eight principles in the consultation and often discussed the relative merits of the REBS mechanism described in chapter 4 of the December 2011 consultation

The majority of responses, including those from DfT, ATOC, and the Rail Freight Group, supported the main principle of REBS, in that it should provide incentives for train operators and Network Rail to work together to improve Network Rail's efficiency. Although Transport Scotland's on feedback on REBS was not as positive as other stakeholders, it was broadly supportive of new measures that support a more integrated approach to the management and delivery of rail services and help to improve efficiency.

A number of consultees suggested that REBS could be a default mechanism with operators also able to enter into bespoke / alliancing arrangements with Network Rail. For example, ATOC believe that there will be additional benefits brought about by bespoke deals and that the REBS mechanism should be the basis upon which to promote efficiency and share the benefits across the industry.

Respondents did, however, have concerns about the structure and practical implications of a route-level mechanism, with exposure to upside and downside risk. These concerns included:

- (a) the difficulty of measuring Network Rail's efficiency, with freight operators highlighting that the existing national EBSM has yet to pay out due to issues with Network Rail's reporting of efficiencies;

(b) as a result of Schedule 9 arrangements, there could be a situation where although secondary operators were exposed to REBS, the lead operator was not;

(c) exposure to downside risk in the mechanism, which operators such as First Group, Go-Ahead and Freightliner, considered would dilute Network Rail's incentives to outperform, whilst adding to franchising costs;

(d) the potential for there to be an excess administrative burden for companies that operate across a number of operating routes; and

(e) the ability to influence Network Rail, which some respondents thought would be particularly difficult for small operators.

Q4.2 *What are your views on our proposed design of a route-based efficiency sharing mechanism, as described in chapter 4 and in annex B? To what extent do you think they will improve the incentives on train operators to work with Network Rail to reduce its costs?*

Chapter 4, and in particular annex B, of the December 2011 incentives consultation covered some of the more detailed aspects of how REBS might work in practice. Responses to this question raised some of the same points as in Q4.1. For example, there were concerns around exposure to downside risk and difficulties with measuring efficiency. Alongside these general comments, there were mixed views on different aspects of the proposal for REBS. We summarise these points below:

(a) Pteg suggested that the disaggregation of REBS should be more granular than operating route, although this view was not shared by others;

(b) a common concern of consultees related to how REBS would interact with bespoke arrangements / alliances with First Group, DfT, and Stagecoach, amongst others, asking for additional details on this area;

(c) Network Rail and Stagecoach considered that REBS should include efficiencies in schedule 4 and 8 costs as this would otherwise create a perverse incentive for operators, i.e. operators could encourage Network Rail to reduce costs at the expense of performance, yet they would be sheltered from worsening performance under Schedule 4 and 8, but would benefit from increased efficiency via REBS pay-outs. However, Network Rail, did not think that property income should be included and that this would be more suited to bespoke arrangements, given Network Rail's existing focus on generating revenues from property;

(d) Network Rail also made it clear in its response that it did not agree with the asymmetric nature of our proposal on REBS, i.e. that Network Rail would pay out 25% of outperformance but only receive a 10% contribution from operators in a case of underperformance, and preferred a symmetric approach;

(e) Transport Scotland questioned the sustainability of the mechanism but suggested that REBS could be an enabler for future bespoke arrangements;

(f) only one respondent commented on the de minimis level / threshold which could exempt small operators from the mechanism. The respondent agreed with introducing such a threshold as it questioned how much impact smaller operators would have over Network Rail's costs;

(g) a number of consultees including ATOC, Network Rail, Passenger Focus and Freightliner highlighted the importance of the governance process that would support REBS. For example,

Network Rail had concerns about the level of evidence that train operators would have to provide in order to qualify for REBS pay-outs and ATOC highlighted the need to have clear governance arrangements, where the interests of secondary operators are protected; and

(h) DfT asked that we consider how to protect taxpayers and farepayers interests, and also how these parties would share in the benefits of improved partnership working.

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?*

Almost all responses, including passenger operators, ATOC, Transport Scotland and DfT were supportive of alliances/bespoke arrangements. Stakeholders considered that bi-lateral agreements are likely to:

(a) be more sustainable in the longer-term than REBS and reflect local issues and the different approaches taken by train operators;

(b) help facilitate a more collaborative / focused working approach between train operators and Network Rail, helping to drive changes in behaviour and deliver efficiencies; and

(c) give more flexibility to train operators and Network Rail to agree mutually beneficial arrangements which suit the specifics of each situation.

The notable exceptions to this support were freight operators. They had concerns that bespoke arrangements between Network Rail and the dominant operator on the route might capture the majority of any potential gains that would otherwise be achieved via REBS, and that these arrangements might 'force' through changes to network capability that were not beneficial to other train operators. Additionally, they suggested that if one freight operator entered into a bespoke arrangement, this could lead to discrimination against other freight operators. Freight operators asked for further work to be done in order to address their concerns.

Q4:4 *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?*

Although most responses to this question re-iterated views to the previous three questions, the key points were as follows:

(a) Transport Scotland suggested that it would like to see the impact of REBS at a route-level rather than in aggregate, and also to understand the impact on Network Rail's revenue requirement;

(b) Network Rail agreed that a 'downside' could be introduced to REBS without significantly increasing train operators risk and that by introducing this downside, Network Rail's risk exposure is lower than it would be without it;

(c) Stagecoach asked that further work be done on: assessing whether route-level baselines are achievable; how we will measure efficiency savings; and determining the level of engagement required by train operators to demonstrate involvement; and

(d) Freightliner did not consider the current proposal acceptable, based on our analysis of risk in annex B. Freightliner considered our assumption of train operator profit, i.e. 6% of turnover to be too optimistic for the freight sector, and also questioned the basis for our assumptions on the expected variation in route costs compared to the baseline. Freightliner suggested that freight operators would rather opt-out of the REBS mechanism when faced with this level of risk.

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?

Responses to our proposal to expose train operators to Network Rail's costs at a periodic review were generally mixed. A number of stakeholders, including Network Rail and DfT, stated that they were supportive, in principle, while requesting further details of how the mechanism would work in practice. Other respondents, notably some train operators and Transport Scotland, expressed concern around the ability of operators to effectively influence Network Rail costs and suggested that this mechanism would increase the risk profile of new franchises. Another concern from train operators was that with a wide variability in the levels of fixed and variable charges across control periods, and gaps remaining in the industry's asset information, such a mechanism would increase franchising costs.

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