ATOC

Association of Train Operating Companies

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PERIODIC REVIEW 2013: FIRST CONSULTATION

Thank you for the opportunity to comment on your initial approach to PR13. We have set out our detailed response to the consultation questions in the attached appendix. However, as a first step, we believe it is important to establish some general principles to guide the overall process and the key objectives the PR13 process should be aiming to achieve.

The McNulty Rail Value for Money Study has set out an ambitious goal for the industry to deliver a 30% reduction in unit costs by 2018/19. This is a significant challenge and the PR13 process is a key mechanism for taking forward many of the recommendations made by the McNulty Review. In this context it is important that the design of the regulatory framework for CP5 reflects the following broad principles, namely that it should:

- Be clear, focussed and simple for industry parties to understand and operate within;
- Drive value for money outcomes;
- Encourage the right behaviours through a clear and consistent set of incentives;
- Enable a clear link to be established between the provision of a high quality service offer to passengers and freight customers and the infrastructure activity required of NR to support this;
- Allow the industry sufficient freedom to determine how it will deliver the outputs Government wishes to buy;
- Facilitate closer industry cooperation between TOCs and NR at a local level and;
- Encourage greater transparency and sharing of information with the aim of optimising whole industry outcomes.

Following these principles, in our view the key objectives for PR13 should be to:

1. **Continue to drive improvements in NR efficiency and encourage TOCs and NR to work more closely to improve efficiency at a local level.** Improvement in NR efficiency remains the biggest prize and to achieve this will require:

   - Establishment of separate price controls and outputs at the route level and, potentially, separate efficiency assumptions. Separate price controls could potentially be established at a sub-route level where appropriate and where such an arrangement could help incentivise more efficient behaviours. NR should however continue to be able to manage risk at a national level;

- TOCs sharing in NR efficiency outperformance, disaggregated to NR route level. It is important both that pre-CP4 franchises are included in this. Moreover there should be arrangements in place to permit TOCs to continue to share outperformance beyond the end of control periods. This will be important in supporting the business case for TOCs to improve NR efficiency;
- Recognition that, while route-based arrangements are to be encouraged, some TOCs will continue to operate across the national network (or multiple NR routes) and therefore some form of de minimis position will be required for these TOCs that can be adjusted by agreement at the local level;
- Local accounting within NR in order to track progress on efficiency at route level;
- Strong transmission mechanisms to ensure incentives are translated into action at local level within NR. Some incentives in the past have failed to make an impact on decision making, particularly the volume incentive;
- Greater sharing of information by NR in order to inform decision making and ensure incentives genuinely do drive behaviours;
- Real empowerment of NR managers, including linking remuneration to local performance;
- A recognition that assets – such as stations and depots – will transfer from NR to TOCs during CP5 and that there must be mechanisms in put in place as part of PR13 to effect the related shift in responsibilities and funding.

2. **Reinforce the role of TOCs as customers of NR**. This can be achieved by:

- Routing the fixed charge through TOCs;
- Moving the balance towards variable charges rather than fixed charges, incentivising NR to maximise access in line with a more typical customer/supplier relationship;
- Increasing the amount of investment channelled through TOCs, for example at stations but also potentially in other areas;
- Directly linking the objectives and remuneration of local NR managers to successful delivery to their TOC customers.

3. **Focus on setting outputs that really matter.** There needs to be a better balance between specific NR outputs and whole industry outputs, and flexibility in how these are to be achieved. Similarly there must be explicit recognition that safety is a matter for individual duty holders. In practice this means:

- Giving prominence to NR outputs that support the service offer TOCs make to their customers or which measure efficiency;
- Allowing the industry flexibility to determine the best way to achieve wider objectives such as performance, passenger satisfaction, information provision and investment to manage passenger demand. This could mean, for example, refining and applying more widely the sort of approach that is used for PPM i.e. setting an overall target or trajectory but allowing TOCs and NR to determine the most appropriate mix of infrastructure and operational solutions to deliver it, according to local circumstances;
- Greater use of funds that can be accessed by both NR and TOCs to deliver specific outputs. These funds need to be supported by a clear, rigorous and enforceable

governance framework to ensure that the best VFM solutions are being sought and implemented, through the RDG process. The current mechanisms are poor, there needs to be genuinely joint governance of the funds;
- Not setting a regulatory target for safety. There is already an established legislative framework to guide duty holders and hold them to account.

4. **Encourage Network Rail to focus on the drivers of TOC revenues and costs** by:

- Improving the operation of existing incentives with a particular focus on addressing those areas where incentives (or lack of them) have clearly failed to encourage the right behaviours, for example reducing EC4T losses.
- Encouraging ‘line of sight’ local deals to incentivise NR to improve the bottom line of TOCs;
- Reviewing the operation of volume incentive (or moving towards variable access charges rather than fixed access charges) to ensure that it properly incentivises decision making on the ground within NR, probably by linking it explicitly to the remuneration of local managers.

5. **Facilitate the potential for NR to raise capital without explicit government guarantees in the long term beyond CP5.** While recognising that there are potential benefits from the increased discipline and incentive properties arising from raising capital through open market operations, NR is undergoing significant internal reorganisation and at the same time the wider economic and financial climate remains extremely challenging. In this context there needs to be a recognition that:

- The introduction of unsupported debt is probably best considered over a much longer timeframe, say CP6 and beyond. This would provide sufficient time for NR to reorganise and establish a track record for private investors to assess. In the first instance NR needs to be structured and incentivised to deliver the outputs that its customers require, transparently and efficiently. This does not necessarily preclude the consideration of potential future NR ownership structures but this should be done in a long term context; the focus for the current Periodic Review must be on delivering industry-wide outcomes and laying a foundation for future developments.

6. **Increase the use of market-based incentives**. There must be a reduction in the degree to which choice is exercised by regulatory determination rather than through market mechanisms. This means learning the lessons from the CP3 and CP4 reviews and moving towards a regime that:

- Shifts the balance away from fixed charges towards variable access charges. However for this to work there must be real linkages between the charges levied and actions that TOCs and NR can take to reduce costs; without this ability to respond to the price signal, higher variable charges will simply act as a ‘tax’;
- Gives greater weight to the long term cost of additional demand, for example through long run incremental charges;
- Creates incentives on Network Rail to reduce EC4T losses by establishing an ex ante level of efficient losses which TOCs would be charged. Any difference should be picked up by Network Rail, which would provide a good, commercial incentive to address this important environmental and cost efficiency issue;

- Exposes open access operators to a fairer level of access charges to reflect the true value of the paths they use;
- Ensures the financial incentives to improve performance (Schedule 8) and deliver greater network availability (Schedule 4) reflect current and expected passenger numbers;
- Recognises the financial constraints on both TOCs and FOCs and their need to plan with a reasonable degree of certainty.

7. **Improve the quality and transparency of information on where taxpayer funds are spent**. The lack of transparency has inhibited previous debates on value for money and on the role of Government in franchises, particularly those with a high proportion of cost covered by passenger revenue. We therefore wish to see:

    - Disaggregation of the RAB and debt to establish a more complete picture of the levels of investment on a route, alongside separation of accounts to a route level more generally;
    - Linking NR route level financial data with high-level TOC statutory accounts to provide a holistic view of industry financial performance albeit with safeguards in place to ensure commercial confidentiality is maintained and that available data is applied to progress whole-industry efficiency.

8. **Ensure the ORR has the right capabilities to support industry's delivery in CP5 and beyond.** As flagged in the McNulty Study, there are significant challenges for the ORR and it is important to it has the right mixture of skill sets and resources. This means ensuring ORR concentrates on the core issues (recognising these may be different for PR13 compared to previous reviews) and does not extend the scope of its activity beyond that which is necessary. It also means having the right people and to this end the ORR should undertake a full capability review to ensure it is sufficiently geared up to deliver efficiently the PR13 objectives.

I hope this is helpful. I look forward to discussing these issues further with you and your colleagues.

Yours sincerely

Alec McTavish
Director, Policy & Operations

Appendix: ATOC response to ORR PR13 first consultation questions

Objective for PR13
Do you agree with our proposed objective for the review? If not, what issues would you add or subtract?
ATOC response: See comments above.

High level timetable
Do you have any views on our proposed timetable for the review? Do you need further information to plan your involvement in PR13?
ATOC response: No comment.

Network Rail devolution and price control separation
Do you think our approach to the disaggregation of NR financial and other data to operating route is appropriate? Is the information we are requiring NR to produce set at the right level? Do you have views on the information train operators should produce? *Which aspects of the price control should be separated for England & Wales and Scotland e.g. should the efficiency assumption be separate?* *Do you think there should be further separation of the price control for NR's operating routes and, if so, which aspects of the price control should be separated?*
ATOC response: We support the application of separate price controls at the NR route level and, where appropriate, separate efficiency assumptions. Retaining the flexibility to use different efficiency assumptions is particularly important since there will be routes where the local efficiency potential is much greater than the national average. However within this context we believe NR should be able to continue to manage financial risk and underperformance/outperformance across routes at a national level. Further, we believe there should be scope to go beyond route-based price controls and potentially apply price controls at a sub-route level where circumstances make this a suitable solution. This is most likely to be where there is a single or small number of operator(s) on a discrete section of route and/or where there are distinct differences between parts of an NR route. In practice this approach would probably only be applicable in a limited number of situations. We are supportive of the move towards disaggregating financial data as a means of delivering greater transparency and supporting closer alignment of operators and NR at route level. In this context there should be separation of NR's RAB and debt to establish a clearer picture of investment on each route. As regards TOC data, there must be a clear rationale for its provision: we would discourage the collection of data simply for completeness. ORR must set out how TOC data will add value and how it will influence behaviours and decision making on the ground. In addition, the nature of

the data required and how it is presented will need careful consideration; the disclosure of commercially sensitive financial information could undermine the basis of competition for franchises. Similarly, where a TOC or TOCs operate across multiple NR routes, the data will need to be mapped to the relevant NR routes in such a way as to make sense and provide real benefit in terms of being able to benchmark routes and understand the balance of costs and revenues in each.

Setting outputs

Is the current approach to defining obligations in terms of outputs the best approach? What outputs should be defined? Should there be a move to more use of outcome based obligations? Would another approach be appropriate such as specifying inputs or intermediate measures?

What are your views on how we should compile and present 'scorecards' of NR's performance in CP5?

Should we make use of more 'whole system' outputs over which NR does not have full control, or focus on more narrowly defined outputs which the company is responsible for?

How should output obligations be defined in the context of devolved NR routes with separate price controls?

How should the balance between the number of output obligations and their individual significance be struck?

ATOC response:

ORR’s first priority is to regulate NR: it should be setting NR outputs and ensuring that it delivers them consistent with the requirements of funders as expressed in the HLOSs. ORR should focus on setting NR outputs in areas where there is a genuine impact on service delivery to the final customer and which reinforce NR’s role as a supplier to TOCs. This means focussing on areas such as punctuality performance, network availability, disruption etc. Strong NR performance against these measures will, by extension, drive the achievement of wider industry outcomes such as improved passenger satisfaction.

We do not believe ORR should be extending its range into setting outcomes such as passenger satisfaction; these are by their nature the sorts of measures that best sit with TOCs as the provider of services to end users. Not only that, setting a passenger satisfaction outcome runs the risk of double jeopardy as TOCs could end up accountable to both ORR and DfT for delivering potentially conflicting outcomes that do not add value to passengers or drive appropriate behaviours by industry parties.

We do not believe ORR should continue to set targets for safety as part of the periodic review. Safety is a matter for individual duty holders in the context of existing Health and Safety legislation. Duty holders should not be required to meet separate safety outcomes over and above those established by legislation.

We support setting outputs at route level as this goes with the grain of wider industry reform but this needs to be done in such a way as to provide real benefits, principally to enable the comparison of performance across NR routes. There needs to be recognition of the relationship between greater disaggregation and the sheer number of possible outputs that will require monitoring. In this context establishing a wide and varied range of measures runs the risk of being too complex either to understand or to drive behaviours. We would therefore encourage a focus on setting a streamlined set of outputs that can be easily compared across routes.

We support the greater use of targeted funding attached to the delivery of specified outputs. These funds must be accessible by both TOCs and NR and have transparent, robust governance arrangements in place to ensure that the most value for money solutions are sought. Too often in the past funds have been controlled centrally by NR with an emphasis on infrastructure-based projects that are subject to complex and lengthy internal GRIP processes. There should be a greater emphasis both on finding the most cost-effective solutions – which may not always involve infrastructure solutions – and on ensuring funds are spent quickly.

We also feel there should be tighter regulatory control of funds channelled directly from Government to NR for specific schemes that are currently outwith the periodic review process, for example for Thameslink and Crossrail. This split is unhelpful, primarily because the funding and associated activity is not subject to the same periodic review process applied to other Government-specified outputs, but also because the funding of additional outputs in this way has implications for the NR resources available to deliver the outputs agreed via the control period process.

Improving incentives

Do you have views on how the effectiveness of the existing financial incentives can be improved?

Do you have views on how the effectiveness of NR's incentives to make best use of capacity could be improved?

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

What are your views on exposing franchised train operators to changes in NR's costs at a periodic review?

Do you believe that NR should share in TOC revenue and/or costs? Are there further issues about introducing a revenue/cost sharing mechanism which you would highlight?

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?

Are there further new incentives which you believe should be introduced and what would the benefits be?

Are there other interactions between incentives (and the wider regulatory framework) which we need to take into account?

ATOC response:

There should be a greater emphasis on market-based incentives combined with strong transmission mechanisms to ensure that incentives are translated into real action at the local level within NR. This requires establishing a much closer link between the quality of the service offer to passengers and freight customers and the activity NR undertakes as infrastructure supplier. On a practical level this means directly relating the remuneration of NR managers, both at Board and route level, to how well they deliver to their TOC customers.

There is significant scope to sharpen the volume incentive; currently there is little evidence that it drives behaviour within NR, certainly at a local level. We would therefore recommend inclusion of the volume incentive in the Management Incentive Plan as a means of placing a much stronger onus on both senior executives and local NR managers to facilitate volume growth.

In terms of benefit sharing we support a framework that sets the right incentives for efficiency at a disaggregated level and is clear and transparent. National-level efficiency benefit sharing, while a useful first step, has none of these characteristics and so is unlikely to unlock significant efficiencies.

Taking a more ‘horses for courses’ approach, there should be a base proposition for efficiency benefit sharing at the NR route level that can be tuned according to local circumstances. For example on multiple TOC routes (e.g. WCML) a standard route-based efficiency benefit sharing mechanism would probably work well but on single operator routes (e.g. Chiltern) there should be the ability to introduce different arrangements such as joint ventures or bespoke ‘line of sight’ deals to allow for deeper cost and revenue sharing.

If an upside/downside risk sharing approach were to be adopted, the relative size of TOCs and NR routes needs to be taken into account: NR routes are sizeable businesses in their own right whilst TOCs are comparatively small and highly-leveraged. In this context significant NR underperformance could have a material financial impact on TOCs. Some recognition of this would therefore need to be built into the downside arrangements, for example through a cap on TOC risk.

Furthermore, downside risk sharing requires much stronger governance and oversight of NR than is currently in place at the moment. TOCs must have the ability to genuinely influence NR behaviour, including the ability to challenge local decisions where necessary. Without this, TOCs will simply be exposed to risk but with only very limited ability to control it. Any mechanism developed must not in effect place TOCs in the role of providing insurance to NR in the event of inefficient overspend.

Critically, any efficiency benefit sharing approach that is introduced must allow pre-CP4 franchisees to participate and allow TOCs to share in NR outperformance over the long term. This will require the introduction of appropriate mechanisms to ensure transfers can be made at the end of control periods/franchise ends.

Compared to other incentive mechanisms, Schedules 8 and 4 have worked reasonably well: they provide strong financial incentives for NR to do the right thing. In addition both have been the subject of significant review and/or reform in recent years. In this context we believe there would be more benefit in focussing attention on other incentive mechanisms that have not worked well. If there is to be further reform we believe this ought to focus on further refinement/adjustment rather than wholesale radical change.

More broadly there is an important balance to be struck here between seeking to encourage the right behaviours through existing incentive mechanisms and complementary line of sight deals between TOCs and NR. Both will have a role to play although the latter are likely to become increasingly important over time.

Financial framework

What are your views on the duration of the control period?

Do you think that we should retain the single till approach rather than moving to a dual till approach?

Do you think that out overall approach to risk and uncertainty in PR08 was appropriate and are there any improvements that could be made for PR13?

NR faces a number of risks. At this stage do you have any views on how general inflation risk and input price risk should be addressed?

We plan to retain the same high-level approach to amortisation in CP5 that we introduced in CP4. What are your views?

ATOC response:

We do not consider CP5 is the appropriate timeframe within which to introduce unsupported debt. NR is currently engaged in a significant internal reorganisation and in light of this any proposals to change the mix of its debt run the risk of distracting attention from more immediate and pressing priorities. The key challenge in the near term is to establish proper devolution at the NR route level alongside closer integration with train operators.

Even assuming the economic conditions were sufficiently benign that changes in the way NR is financed could be considered feasible, NR would first need to demonstrate it had sufficient corporate/financial discipline to be able to operate with the proposed mix of supported and unsupported debt. Only when it has established a track record in this regard can private investors be expected to invest.

In terms of the balance of NR's income, we consider that it should be routed via TOCs rather than paid directly to NR in the form of Network Grant. This will reinforce the role of TOCs as NR's customers.

While we are not wedded to the current 5-year control period per se, it appears to strike broadly the right balance between providing certainty and stability on the one hand and flexibility on the other. Were a longer control period contemplated there would need to be mechanisms to respond to unforeseen shocks, for example through the use of more regular re-openers. In longer control periods there also remains the risk that NR could build up significant back-ended liabilities.

Structure of charges

Do you consider our charging objectives remain appropriate?

What are your views on the geographical disaggregation of variable usage charges?

What are your views on introducing a charge levied to reflect network scarcity?

What are your views on a reservation charge (assuming it would be set to be financially neutral for freight operators)?

Should passenger open access operators pay charges that exceed variable costs? How should charges be calculated?

What are your views on the proposals to improve incentives to reduce traction electricity consumption? *Should we put a cap on certain freight charges in advance of our determination and should these be linked to other charges?* *Do you have views on the interactions between these possible changes and when they should be implemented - for example whether some changes should only be introduced after other changes have 'bedded in'?*
ATOC response: As noted in the consultation we continue to advocate shifting the balance away from fixed charges towards higher variable charges. This is consistent with wider franchise reforms designed to provide TOCs with more freedom to vary output according to demand. Higher variable charges would ensure broader macroeconomic shocks are borne more equitably between TOCs, NR and the wider supply chain. We are of the view that supporting the financial stability of the industry, not just the IM, in this way should be one of ORR's explicit charging objectives. Importantly, shifting the balance from fixed charges to variable charges must be underpinned by mechanisms that enable TOCs to respond to the price signal given by the charge, either by adjusting their outputs or by initiating a dialogue with NR to reduce costs. Without the ability for TOCs to respond in this way, higher variable charges simply act as a 'tax'. Linked to this, the consultation highlights the role of the existing franchise change provisions in insulating TOCs from changes in NR's costs. In considering the interaction of these provisions with charging, it is important to bear in mind both the potential impact of a shift from fixed to variable charges and the approach taken towards setting the charges themselves. In terms of the former, a shift to (higher) variable charges amplifies the need for mechanisms to enable TOCs to vary their outputs in response. In terms of the latter, were TOCs to take on greater risk associated with changes in NR costs, ORR would need to ensure charges were based on a consistent methodology and that any changes were a result of changes to underlying costs. In the past this has not always been the case, with changes to charging often arising from adjustments to the methodology instead. We feel there is merit in further consideration of a charging framework based on Long Run Incremental Costs (LRIC) at the devolved route level. The current network is heavily constrained in places and long term demand projections indicate substantial growth is likely to continue over the coming decades. In this context a LRIC approach would provide the right price signals for the long term development and expansion of the network and could potentially facilitate greater enhancement investment by third parties by providing a means of recovering the costs of the assets over their useful life. However, as with unsupported debt, LRIC-based charging is probably best seen as a longer term objective beyond CP5 given the complexity involved and the need for a smooth transition from the current arrangements. We are broadly supportive of the disaggregation of the variable usage charge as it flows with the wider devolution to NR route level. It would also support further development of the work undertaken during CP4 to make vehicles more track-friendly in order to achieve reductions in variable charges. However it is important that any such disaggregation is simple and based on real evidence of

the costs of track damage across route types and across different vehicles on individual routes. Similarly, disaggregated charges need to be structured in such a way as to drive the right behaviours – including making the most appropriate use of capacity – not introduce further complexity for little or no discernible benefit As highlighted in the consultation, there is a limit to how easily TOCs can respond to the variable charge incentive and there may be more benefit to be gained from establishing the right efficiency benefit sharing arrangements – so that TOCs and NR care more about each other's costs – rather than very detailed refinement of the variable usage charge.

As regards EC4T charges, while there are arguably already strong incentives on TOCs to reduce consumption the effect of these has been blunted by the lack of any similar incentive on NR to reduce transmission losses and which are instead exhausted across TOCs through the volume wash up. Under these circumstances NR has found it difficult to build a business case to invest in energy efficiency solutions to reduce losses (although we note here that NR has always had specific licence requirements to maintain an efficient network and to maintain adequate information about its assets, neither of which has been enforced with regard to EC4T). To remedy this in CP5 NR should be allowed to recover costs only for an 'efficient' level of losses. This should be set at a level which is considered to be achievable by NR from the beginning of CP5 (i.e. not what losses are now but a view of what they should be in 2014) and progressively tightened over the control period. This would also have the related benefit of providing certainty for TOCs trying to build a business case to fit on-train metering, particularly those on the 3rd rail DC network where losses are likely to be substantially higher than on AC.

We note here that the cross-industry Metering Steering Group will make a separate submission on the detailed EC4T proposals to which we will contribute.

On open access charging there must be recognition of the potential impact of the ORR's proposals on franchise value. If the 'not primarily abstractive' test is to be relaxed then open access operators must contribute a larger share towards fixed costs.

As regards the proposals for a reservation charge, significant work has gone into developing the 'use it or lose it' provisions in Part J of the Network Code. We note the ORR has conducted a review of Part J and would encourage the ORR to discuss the results with industry stakeholders before considering any further charges relating to freight capacity.