GRAND CENTRAL

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**Periodic Review 2013**

**First Consultation**

Dear Richard

This letter comprises the response of Grand Central Railway Company Ltd ("GC") to the ORR's Periodic review 2013 first consultation of May 2011. Where appropriate the same abbreviations are used as in that document. GC's specific consultation question comments are included at the end of the main part of this letter, in addition other comments on aspects of the consultation are detailed by reference to the consultation paragraph number in the appendix to this letter. However there are a number of common threads:

1. Network Rail's corporate structure means that it is not strongly incentivised by financial measures. Therefore cost control is weaker than would otherwise be the case. The consultation on establishing Network Rail's efficient expenditure will be a key work stream in addressing potentially excessive costs. This is exacerbated by;

2. Low operator profit margins, and their small current relative size, mean that financial reallocations between operators and Network Rail have a disproportionate effect on the operators. Therefore fundamental changes may have unintended consequences;

3. Changes that may discriminate against some operators should be avoided, e.g. if revenue or benefit share mechanisms encouraged actions that adversely impact other operators; and

4. The MVA/ITS study and related work will be crucial to the economics of open access and spreading the benefits that competition brings to market size and operational efficiency across the Network.

In respect of specific consultation questions GC comments as follows:

a) Q1 GC agrees that charges should be set to be affordable and act in support of competition. The review should also recognize the competitive environment in which the rail industry operates, e.g. that road transport remains the principal alternative for most rail journeys.

b) Q5 The geographic disaggregation of access charges could add great complexity for operators utilising more than one route.

c) Q8 Network Rail is in a better position to influence whole system outputs than operators, even if it does not fully control them, Therefore measuring Network Rail on whole system outputs may cause it to pay greater attention to its customer needs and overall system performance.

d) Q12 Stronger links with management incentive plans may strengthen the effectiveness of financial incentives.

e) Q13 Scarcity charges and revenue sharing may encourage Network Rail to prioritise capacity for operators with the greatest ability to pay rather than those generating the greatest overall economic benefits for society. Therefore a balance of incentives is necessary.

f) Q14 It is uncertain how regional benefit sharing would encourage long term improvement under the current franchise structure.

g) Q15 Exposing franchised passenger train operators to changes in Network Rail costs in a comparable way to freight and open access passenger operators should encourage engagement and long term improvement, as evidenced by the freight sector. Without the engagement of such a significant proportion of the industry the scope for overall improvement may be much reduced. However this will require significant changes in franchising.

h) Q16 The financial scale and performance of most non franchised operators means that revenue or cost sharing that is material to Network Rail may be very hard to implement.

i) Q17 The competition aspects of bespoke benefit sharing arrangements will need to be carefully considered, overall network utility must be maintained. Increasing the level of contestability of expenditure would be expected to reduce some of Network Rail's excessive cost levels, e.g. for station and car park works.

j) Q20 If variable charges are correctly calibrated there is a case for setting them for a longer period of time, e.g. more than one "control period". This would provide longer term certainty for operators and reduce industry workload while leaving the remaining "fixed" element of Network Rail's cost to be addressed by regulation, government policy and subsidy.

k) Q23 Network Rail should be encouraged to manage pricing risk to the greatest extent possible.

l) Q25 GC supports the charging objectives. ORR may wish to consider and clarify the relationship between the wider objectives of funders, funder sponsored services and other services.

m) Q26 Geographic disaggregation of variable usage charges will greatly increase complexity for operations that cover more than one route. It might also provide a long term disincentive to maximise route cost efficiency.

n) Q27 The current capacity charge mechanism does not appear to incentivise Network Rail or operators and therefore might be abolished. However the introduction of any new scarcity charge would have to be carefully considered to avoid unintended

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consequences. The overall social and economic benefit of the network must be considered.

o) Q29 Passenger open access operators would have to enjoy the same access rights and conditions as other operators if they were to pay charges in excess of variable costs.

p) Q30 Network Rail should be encouraged to reduce electricity consumption by taking measures to reduce transmission wastage, rather than merely treating it as a fixed uncontrollable cost.

q) Q32 Radical changes should be phased in gradually to mitigate the risks of unintended consequences and perverse incentives.

Please do not hesitate to contact me if you have any questions.

Yours sincerely

David Lowrie

Director

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| Reference | GC Comment |
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| Chapter 4 | Should PR13 have a specific objective of fomenting greater “on network” competition? |
| 6.13 | Sharing surpluses or benefits across routes will reduce the incentives to improve efficiency. |
| 6.26 a | Network Rail’s lack of a conventional profit motive lessens the effect of it retaining benefits. |
| 6.30-6.33 | Benefit sharing creates the moral hazard of there being a fundamental misbalance between Network Rail and its customers in respect of the proportion of their respective profits that they can control. |
| 6.50 | GC’s preference would be for the government subsidy for Network Rail’s fixed cost to be paid entirely via network grant. However if this is impractical a second choice would be for it to be entirely routed via fixed track access charges as advocated, this improves upon the current mixed approach which is perceived as arbitrary. |
| B.24 a | Route “maintenance” costs must to some extent reflect usage. Therefore that element of them might be regarded as “variable” |
| B.24 b | Network Rail’s ratio of debt to equity/reserves at any one time will be an accident of historic financing structures. Therefore debt should not be linked to the RAB. |
| B.24c & B.28 | If Network Rail is not treated as “one company” it will never be able to optimise its financing structure. However many conventional groups of companies obtain funding synergies while having disparate operating businesses, often subject to regulation. Those businesses still benefit from being funded by the central corporate function. |
| B.25 | It would be pragmatic to move to determining efficient expenditure by route in several stages. |
| B.26 | The RAB should be separated by route but not the debt. |
| B.27 | Risk sharing between routes should be as limited as practical as the true financial incentives are already weak. |
| D.11 a | GC considers that the current Network Rail corporate structure means that financial incentives on it are very weak. |

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| D.33 | | GC concurs that the incentives on capex and opex should be equal. |
| D.49 a | | The incentive regime should not be switched off; all parties should be incentivised to aim to improve their own performance. Otherwise a large failure might demotivate managers from attempting small improvements that were still possible. |
| D.49 b | | Changes to bonus payment rates must be carefully considered, if individual corporate hurdle return on investment rates are impossible to achieve it may become impossible to fund improvement initiatives. |
| | | In practice while Network Rail performance can have severe effects on TOC economics it is harder to envisage TOC activities impacting on Network Rail in the short term. Therefore some moral hazard is created by allowing Network Rail to share in TOC induced performance, particularly given Network Rail's very weak financial incentives. |
| D.52 d | | The expected "zero sum game" nature of the current arrangements for franchised operators are unlikely to have a strong impact on Network Rail behaviour. |
| D.56 a | | The possession regime should not be turned off. All parties should be incentivised to aim to improve their own performance. This could lead to behaviour which is inadvertently discriminatory. Managers must always be encouraged to attempt small improvements wherever possible. |
| D.60-bullets | 1st | Greater prominence should be given to the network system operator role via licencing. |
| | 3rd | The profit motivator for operators should suffice. |
| | 4th | Network Rail being exposed to downside as well as upside might be beneficial. |
| | 5th | A new capacity utilisation metric should be developed. |
| | 6th & 7th | The low financial motivation of Network Rail means these would have little effect. |
| D.63 d | | The exposure of franchised, open access and freight operators to variable charges should be on the same basis. This would encourage better long term dialogue and improvement. Fixed costs are unlikely to be capable of being influenced by an individual TOC or FOC. |

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| D.63 e | This would have a proportionately higher effect on the profit of operators than it would on Network Rail. Therefore unexpected consequences might arise. |
| D.63 f | No, the financial incentives on Network Rail are too weak for this to be effective. |
| D.73 | A more valid comparison than the proportion of total cost is the proportion of profit. Operators often exist on low profit margins. |
| D.75 | As one of the few industry national employers Network Rail wage settlements often influence those of the rest of the industry, e.g. wage negotiations can be influenced by settlements with signallers, so Network rail has a strong indirect influence over other parties staff costs. |
| F.4 d & F.8 c | Franchised operators payment of fixed infrastructure costs is compensated for by the support of government for their businesses. The payment of these fixed costs by operators that do not benefit from this support would be discriminatory, even if the rights and conditions of non franchised operators were strengthened. |
| F.12 f | Network Rail's relative indifference to profit means that its sharing of operator revenue would be unlikely to influence it. |
| F.20 & F.21 | GC concurs that the variable usage charge should aim to recover costs that vary with traffic and that it should continue to vary by vehicle type |
| F.25 | Network Rail should first ascertain whether there is a material difference by location. |
| F.28 | Network Rail should be incentivised to minimise electricity leakage rather than treat it as an uncontrollable cost. |
| F.43 | Evidence is emerging that the competition created by open access services grows the market to mean that any negative impact on franchises may be negligible. |
| F.44 & F.46 | GC awaits the study. Several of the options may be impractical or have severe unintended consequences. |