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Your ref:

Our ref:
NRS11-052

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Dear Richard

Periodic Review 13: Response to the Consultation on Objectives

First of all I welcome the opportunity to comment on behalf of Transport Scotland on the ORR's objectives for PR13. My views on the specific questions are contained in the annex to this letter. However, I thought that it may be worthwhile in the first instance to offer some general views on the objectives for the review.

Rail is a vital part of the fabric of Scottish society. Its value to sustainable economic growth in Scotland is well understood by the Scottish Ministers, as is its contribution to transport related carbon reduction through modal shift. This is reflected in the significant level of investment which the Scottish Government has made and plans to make in rail infrastructure and services.

Scottish Ministers are giving consideration to the future structure of rail in Scotland, in particular in the context of the next contract for the provision of passenger services, due to commence in 2014. While Ministers are unlikely to reach any formal conclusions until such times as they have had the benefit of the response to the public consultation on passenger services (due later this year), they have expressed the view that **passengers and freight customers should be at the heart of what the railway looks to achieve. This should therefore be a key objective of PR13.**

The growth in the rail markets over the last decade, and the predictions for continued growth, demonstrates the success of the industry. However, your benchmarking work and the McNulty Rail Value for Money study (RVfM) leads us to the conclusion that greater value for money can be achieved without reducing services. Delivering a lower cost railway must be a rail industry objective when viewed alongside the wider pressures faced by public resources in Scotland. I recognise that there is a wide range of views on how efficiency can best be achieved. **Therefore a critical objective for PR13 must be to maximise value for money for taxpayers and users of the railway, whilst ensuring continuing growth in rail use, and ensuring that the rail industry contributes to the wider Scottish economy, regeneration and environmental objectives.**

PR13 is a key component in what is a critical time for the industry. I have been heartened by the level of collaborative working which is already evident as the industry faces up to the challenges

both in the Scottish network and more broadly in the GB network. It is essential that the approach which you take during PR13 helps to consolidate this and where possible improve collaborative working in all areas and at all levels of the industry. In this respect, the ORR should primarily be a facilitator of agreed industry solutions. **Therefore a key objective of the review should be that it is undertaken in a spirit of collaboration, partnership and transparency, with appropriate consultation at each stage in the process.**

The Scottish Government takes an evidence based approach to its work. This lends itself to a decision making process which is robust, with appropriate analysis and understanding of the current and future effects of decisions. When aligned with transparency and partnership working it also enables stakeholders to have a clear understanding of why a certain conclusion was reached. **A strong evidence base for key decision making should therefore be an objective of PR13.**

It is often said that the railway frameworks and processes are complex: RVfM identified it as a real barrier to innovation and efficiency. PR08 introduced a relatively complex set of regulatory frameworks: PR13 represents an opportunity to simplify those. **A key objective of PR13 should therefore be: simplicity; an opportunity to sweep away the unnecessary and the overly complex. This will also help to ensure alignment of incentives with other industry partners.**

I believe that PR08 was generally successful, particularly given that it was the first periodic review after the transfer of certain rail functions to the Scottish Ministers under the terms of the Railways Act 2005. I was particularly grateful for the work that the ORR undertook in the separation of the price controls and the RAB, which as things transpire have meant that Scotland is 'ahead of the game' with regard to some of the emerging themes in rail reform. However, the Nelson report on PR08 did identify areas for improvement with regard to the ORR's approach to the review in Scotland. With this in mind, I would highlight the following-

- this consultation is heavily influenced by the conclusions of the RVfM study. However, the study related specifically to the functions of the Secretary of State, not Scottish Ministers. As outlined above, the Scottish Ministers are still considering the future structure and provision of rail services in Scotland, and whilst RVfM will be a key piece of evidence, it will be one of a number which will be taken into consideration, including the outcomes of our consultations on passenger and freight services. The ORR should therefore not make any assumptions with regard to the support or otherwise of the Scottish Government for the conclusions of RVfM, nor that the Scottish Ministers will automatically seek to replicate any decisions taken by UK Ministers;
- we have an opportunity in Scotland with the dovetailing of the next contract for passenger services and the beginning of Control Period 5 in 2014. The ORR should work with us to ensure that we maximise the opportunities presented by this, particularly as we look towards the possibility of closer alignment between track and train. The ORR must therefore be properly and fully equipped to deal with circumstances where the right regulatory solution for Scotland may be different, in some cases perhaps radically so, from the rest of the GB network; and
- we have as yet to receive an assurance from the ORR that NR are on schedule (or otherwise) to deliver all of their Control Period 4 outputs for Scotland. This information will be critical in the approach we take to developing our HLOS and SoFA, and we would therefore seek this analysis as part of the periodic review.

Taking the above into account, **an objective for PR13 which is of critical importance is that the ORR is able to fully recognise, understand and interpret the policies and priorities of Scottish Ministers.** This will enable you to adapt the PR13 process and conclusions in order to deliver a periodic review settlement which is the right one for the Scottish network, whilst also fitting with the wider national network, and which serves as a platform for the long term success and sustainability of the industry in Scotland.

I would take the opportunity to re-iterate the point that I made at the workshop in Dynamic Earth that we need to challenge existing thinking and processes in PR13 to a much greater extent than we did in PR08. It is critical that the ORR leads in this and actively encourages the industry and funders to think critically and innovatively. In this respect, I look forward to seeing the Scottish IIP which is due to be published in late September/early October and the ORR's advice to Ministers in February next year.

Finally, there are a range of areas in the specific questions where I have requested that the ORR provide further, more detailed analysis of the effects on the Scottish network. Given the constraints on the timescales it is critical that this is undertaken as soon as possible. Therefore I should be grateful if you would contact John Provan (john.provan@transportscotland.gsi.gov.uk) from my Rail Strategy Team to discuss how best to take this forward.

Meantime, I hope these comments have been helpful, and I look forward to receiving feedback on the outcomes of your consultation.

Yours sincerely



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FRANCES DUFFY
DIRECTOR RAIL

ANNEX

Response to the individual questions in the consultation

Proposed Objective

Q1 Do you agree with our proposed objective for the review? If not, what issues would you add or subtract?

I am broadly supportive of the objective, but consider that the word 'enables' should be amended to read 'requires'. I would also suggest that some text should be added which recognises the respective roles and functions of the Scottish and UK Ministers, and that the ORR's approach and conclusions may differ to respond to differing policies and priorities. Should this make the objective overly complex, the ORR might wish to consider the creation of a separate overall objective for Scotland.

High-level timetable

Q2 Do you have any views on our proposed timetable for the review? Do you need further information to plan your involvement with PR13?

For clarity, the timetable should recognise that a separate IIP for Scotland will be published, and the ORR should confirm whether the date in the implementation phase (page 39) should be Nov/Dec 2013.

Whilst I am mindful that there are regulatory implications in having different commencement dates for Control Period 5 in different parts of the network, this should not unnecessarily constrain efforts to ensure that we fully exploit the opportunities of the dovetailing with the new contract for passenger services in Scotland. I am of the view that it would be worthwhile exploring arrangements whereby certain provisions within the Determination can be switched on to tie in with dates in the new contract, and would welcome more detailed dialogue with the ORR on this issue.

Price Control Separation

Q3 Do you think that our approach to the disaggregation of Network Rail financial (and other) data to operating route is appropriate?

This is already in place to a certain degree in Scotland, therefore the real value for Scotland in extending this to the rest of the network may be in facilitating comparative regulation. In this respect, I would welcome further detail from the ORR on the likely benefits of such an approach as it relates to the efficiency of the network in Scotland, and how this will augment the analysis already undertaken e.g. international comparison.

Is the information we are requiring Network Rail to produce set at the right level?

The current regulatory accounts for the Scottish network do not lend themselves to an easy understanding of the effects of the disaggregated costs of the centralised NR functions. This is critical if we are to achieve a full understanding of the costs of rail in Scotland, in particular as the policy of decentralisation comes into effect.

Do you have views on the information train operators should produce?

As a general principle, I would support simplicity and transparency, within the confines of commercial sensitivity. In addition, I would caution that transparency does not necessarily mean more: too much information can in itself lead to further complexity. Therefore the aim of the ORR should be for quality, target information which is disaggregated at an appropriate level.

Q4 Which aspects of the price control should be separated for England & Wales and Scotland, e.g. should the efficiency assumption be separate?

In general I require further analysis from the ORR on a range of areas for further separation, such as the financial framework, approaches to the RAB, the Network Code, and the incentives regime.

On the specific question of a separate efficiency assumption for Scotland, in principle I would be supportive of exploring this. In order to do so, I would require the ORR to provide further, more detailed analysis, as intuitively a number of variables would have to be in place before such an approach would be truly effective. For example, there would have to be a consistent use of benchmarking and leading edge targets, and the assessment for Scotland would have to be carried out separately i.e. not simply a disaggregation of a GB position. In addition, I would require assurances that the efficiency assumptions for Scotland which were based on comparability with European rail operations reflected the dynamics of the network in Scotland, recognising areas that differ from the GB network.

Q5 Do you think there should be further separation of the price control for Network Rail's operating routes and, if so, which aspects of the price control should be separated?

Please see response to Q4.

Outputs

Q6 Is the current approach to defining obligations in terms of outputs the best approach? What outputs should be defined?

The periodic review should be focussed on the delivery of the Scottish Ministers' outcomes for the Scottish network as articulated in the HLOS and in their Guidance to the ORR under Section 4 of the Railways Act 1993.

Clearly, specific outputs will be required to deliver outcomes, some of which may also be articulated in the HLOS. The correlation between the two should be clearly demonstrable in the conclusions reached by the ORR.

Should there be a move to more use of outcome based obligations?

Please see response to Q6 above.

Would another approach be appropriate such as specifying inputs or intermediate measures?

As a general principle outputs should be clearly defined, easy to understand and easily measurable. In this respect, the ORR should consider taking a SMART approach to the setting of outputs. In addition, the industry should have a degree of flexibility in the delivery of the outputs, which supports innovation and efficiency. Therefore it is my view that specification of

inputs by the ORR should be kept to a minimum, although it may be appropriate under some circumstances to specify inputs in areas such as enhancement schemes.

Q7 What are your views on how we should compile and present 'scorecards' of Network Rail's performance in CP5?

I would broadly support maintaining the current system of scorecards, which would enable consistency and comparability with CP4. I am also supportive of further exploration of where the current system can be enhanced, particularly in the areas of value for money and customer satisfaction, but in a way which maintains an appropriate balance with other outputs, such as performance.

Q8 Should we make more use of 'whole system' outputs over which Network Rail does not have full control, or focus on more narrowly defined outputs which the company is fully responsible for?

In principle, I am supportive of whole system outputs, which are supportive of closer collaboration between track and train. However, this would require the industry and funders to come together to define and agree these outputs and the outcomes that they are designed to achieve. In this respect, it is not clear how the ORR would reconcile the regulatory and contractual arrangements in order that neither the TOCs nor NR were disproportionately exposed to the actions of the other party. This seems likely to require close cooperation in the development of the next contract for passenger services and the periodic review for Scotland to ensure consistency.

I would welcome further discussions with the ORR on this.

Q9 How should output obligations be defined in the context of devolved Network Rail routes with separate price controls?

For the Scottish operating route, this issue has been largely addressed through the legislative roles of the Scottish Ministers under the 2005 Act, the production of the Scottish HLOS and the degree of price control separation already in place for Scotland.

Q10 How should the balance between the number of output obligations and their individual significance be struck?

All outputs should be significant within the context of delivering the outcomes of the review: otherwise they would be superfluous. As outlined in my general comments, passengers and freight customers should be at the heart of this review, and therefore any outputs related to this may require greater prominence. Similarly with the value for money aspects of the review. However, this should not be to the detriment of other outputs.

Q11 Should Network Rail's output obligations include a specific safety requirement, different from its legal obligations?

This is a reserved matter. However, Scottish Ministers should be fully consulted on any proposals with regard to safety which go beyond NR's legal obligations.

Incentives

Q12 Do you have views on how the effectiveness of the existing financial incentives can be improved?

NR is a provider of public services, primarily funded by the tax payer. It also has clearly defined outputs set by the ORR through periodic review - based on specifications from the Scottish and UK Governments - which link to the NR Management Incentive Plan (MIP). This raises a question as to both the effect and the appropriateness of a regime of additional corporate financial incentives, particularly given that these are met through public resources.

While the principle of incentives and the link to outperformance is understood, more challenging outputs (such as the efficiency targets) linked directly to the MIP, and which include provisions dealing with failure as well success, may provide a greater incentive to NR to operate to its maximum potential and be a more appropriate approach given the effects of constrained public resources on other public services. In this respect the ORR should ensure that the MIP is fully aligned to the delivery of Scottish outputs both at route and at corporate level. Given their centrality to what the railway is aiming to achieve, there should also be a clear link between financial incentives – either at corporate or individual level, or both – and passenger and freight customer satisfaction.

An Institute for Fiscal Studies (¹) report which looked at incentives in the provision of public services highlighted that a 'mission', behind which the whole organisation is aligned, can be a more powerful incentive than financial reward. This has been a longstanding, and often very successful, dynamic of the GB railway industry. I would welcome feedback from the ORR on their consideration of the availability of non-financial incentives within the regulatory framework.

Where incentives are put in place, these need to be fully aligned with those of the train operators. The correlation between the incentives and the delivery of the outcomes and outputs set by Scottish Ministers should also be clearly demonstrable. In addition, I would welcome views from the ORR on how they will provide an assurance that any regulatory incentive regime introduced for Control Period 5 will dovetail with the provisions in the new contract for passenger services in Scotland.

On the one hand the ORR consultation seeks simplicity in the incentive regime, but on the other hand it suggests additions to the current regime which would inevitably lead to further complexity. As with all aspects of the regulatory framework for Control Period 5, I am of the view that simplicity is key and should be one of the aspirations, along with value for money and efficiency, which is given the greatest weight in considering regulatory incentives.

Q13 Do you have views on how the effectiveness of Network Rail's incentives to make best use of capacity could be improved?

Experience during the current incentive regime has shown that by only providing incentives for one aspect of the train planning mix: performance, there has sometimes been a detrimental impact on other aspects such as capacity and published journey times. It is vital that future incentives are balanced to ensure that high performance is retained, but the efficient use of capacity becomes a key objective, along with maintaining or ideally improving journeys for users (freight and passenger). This is an area where a whole industry approach is likely to offer the optimum outcome, so incentives need to be structured to ensure that the optimum use of capacity is a key, shared industry outcome.

Q14 Do you agree that we should include a regional efficiency benefit sharing mechanism calculated at the Network Rail route level?

¹ 'Incentives, Choice and Accountability in the Provision of Public Services', The Institute for Fiscal Studies, 15 May 2003

There is not a compelling body of evidence within the consultation document or the literature published by RVfM which would enable us to reach a formal conclusion on whether or not cost and revenue sharing arrangements were the right way forward for the network in Scotland. In addition, we would not expect the ORR to include the Scottish operating route in regulatory arrangements for cost and revenue sharing without securing explicit agreement from the Scottish Ministers.

Intuitively, I can see where such arrangements would help to facilitate closer working relationships between track and train. However, there is a lack of evidence, particularly with respect to the network in Scotland, on how efficiency benefits are derived from such arrangements, what the level of those benefits are in terms of value to the taxpayer and how long these would take to realise. In addition, there is no evidence as to the costs of the introduction of such a system and what the risks are.

Given this, I would ask that the ORR provide a detailed analysis as to the effects of the various cost and revenue sharing options with respect to the Scottish network, which would form the basis of more detailed discussions with the ORR on this issue.

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

Please see response to Q14 above.

In addition to the above, this proposal will expose both NR and the TOC to a process in which they have little or no formal control over the final outcome. This will serve to increase their risk exposure, and in the case of the latter may result in increased franchise premia. I would also welcome the ORR's views on this provision in circumstances where there was a dovetailing of the start dates for the commencement of the contract for passenger services and the control period (Control Period 5 and beyond). Intuitively it would appear to render this particular provision ineffective.

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?

Please see response to Q14 and Q15 above.

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?

In line with our response to Q14 above, we would expect to receive detailed analysis from the ORR with respect to Scottish enhancement projects identified in the HLOS.

Q18 Are there further new incentives which you believe should be introduced and what would the benefits be?

I am of the view that the new incentives suggested in the consultation document, such as carbon reduction, effective capacity utilisation and innovation should be a matter of good practice and effective corporate governance rather than driven by financial incentives. In this respect, as with all areas of NR operation and governance, I would expect the ORR to ensure that NR's policies and priorities were working to greatest effect in providing an efficient railway less reliant of subsidy.

Q19 Are there other interactions between incentives (and the wider regulatory framework) which we need to take into account?

Simplicity is the key.

Financial Framework

Q20 What are your views on the duration of the control period?

As outlined earlier, it is important that we are able to maximise the benefits of the dovetailing of the contract for passenger services and Control Period 5 in 2014, particularly as a lever for closer working between track and train. In the longer term, there is a strong argument for exploring the continuation of this, the timing of which should be driven by the length of the passenger services contract. Given this, and the decentralisation to route level, there is also an argument for exploring different lengths of Control Period in different parts of the network.

In circumstances where a control period was more than 5 years, interim, light touch reviews may be a possibility in order to give certainty to funders and to reflect any changes in economic circumstances. This could be supported by appropriate reopening provisions which would accommodate unforeseen, fundamental changes in circumstances.

We are starting a periodic review at a time where the ORR has not as yet been able to fully assess the success or otherwise of Control Period 4. This would suggest a lengthening in the control period may be appropriate. Alternatively, a review of how NR progress is measured and more importantly predicted during the life of a control period may be necessary.

Q21 Do you think that we should retain the single till approach rather than moving to a dual till approach?

An intuitive risk with a dual till approach is a short term increase in costs. If this is the case, I would not be in a position to support such an approach. However, I would look to the regulatory framework to support NR in increasing non periodic review activity and income generation, which should feed directly into reducing the subsidy requirements.

Q22 Do you think that our overall approach to risk and uncertainty in PR08 was appropriate and are there any improvements that could be made for PR13?

The allocation of risk must be consistent with the financial framework. The financial framework must deliver value for money and maximise efficient outputs, particularly given the current pressures on public resources. The approach in PR08 created a number of new mechanisms to deal with risk and uncertainty, including the risk buffer. A full review of all separate funds is required for PR13. This should include an assessment of whether the benefits derived from these funds are consistent with original expectations, the relationship between these funds and the build up of NR cash reserves, and their relevance for the full CP5 determination. A key concern is that that the more discretionary funds that NR is able to accumulate then the less responsive it may be.

Q23 Network Rail 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?

In general, I am of the view that risk should be borne by the party best placed to manage it, with all risks borne by NR unless specific regulatory mechanisms exist to share it with other parties. The ORR should also consider the various funds available to NR to allow for broader risk

management, how they have been used and whether they remain necessary for Control Period 5. I would welcome further evidence and discussion with the ORR on this particular issue.

On the specific question of inflation and input price risk, the current approach to managing this causes budget uncertainty for the Scottish Ministers with the risk that outturn inflation is higher than the assumptions made for spending plans.

I would welcome further consideration of options to remove this in-year risk and provide greater certainty for forward planning. This could include a fixed inflation assumption, validated by the ORR, being applied to NR's revenues with any differences accounted for in the next periodic review. The merit of alternatives to RPI indexation should also be considered.

Q24 We plan to retain the same high-level approach to amortisation in CP5 that we introduced in CP4. What are your views?

In principle, I would be supportive of a continuation of the Control Period 4 approach to amortisation. However, I would seek assurances from the ORR that this approach is consistent with the state of the assets on the Scottish network, which may be in slightly better condition, or have longer life than some other parts of the network.

In principle, a steady-state railway should result, at the very least, in a steady-state RAB. With the efficiency benefits that the ORR evidence suggests is possible, I would expect an incremental fall in RAB costs, matched by a reduction in the related long-term subsidy requirements.

Structure of Charges

Q25 Do you consider that our charging objectives remain appropriate?

In line with the Transport Scotland response to your earlier consultation on TACs, I am broadly supportive of your objectives for charging.

Q26 What are your views on the geographical disaggregation of variable usage charges?

In principle, a geographic approach to VTACs may provide a greater correlation with the actual costs of maintenance and renewal that emerge from the separate Network Rail routes. However, for this to be most effective it should be assessed at an individual route section level, and taken alongside vehicle type: this will help to truly reflect the cost of operating certain types of vehicle on certain parts of the network, and ideally influence operator routing and vehicle decisions.

Neither the consultation document nor the previous analysis provided by the ORR and CEPA presents a compelling argument either way on the geographical charging. Therefore I would expect to see further detailed analysis from the ORR as part of this periodic review on the effects as it relates to the Scottish network.

Q27 What are your views on introducing a charge levied to reflect network scarcity?

In principle, an economic approach to charging, in particular scarcity, has merit. However, it is predicated on true above-rail competition which is not the reality as things stand in Scotland. The risk is that such an approach will only serve to add further complexity to the system, which in itself could constrain competition.

In a system of centralised planning, the issue of network scarcity may be better tackled through efficient access planning rather than attempting to manage or influence this through economic levers. In this respect, we would look to the ORR to ensure that the regulatory planning frameworks were appropriate and operating to greatest effect.

Q28 What are your views on a reservation charge (assuming it would be set to be financially neutral for freight operators)?

While in some circumstances reservation charges may be appropriate, it may also serve to counteract the ability of freight operators to satisfy customer demands in a way which makes them competitive with other modes of freight transport, in particular road haulage. At a strategic level, funders may seek to reserve paths in advance of the completion of infrastructure projects and it would not seem appropriate, given the level of investment already made by the funders, to levy further charge in those circumstances. As with my comments on Q27, this issue may be better addressed through efficient access planning rather than a charging regime.

Q29 Should passenger open access operators pay charges that exceed variable costs. How should charges be calculated?

There is an argument that the process for assessing charges for open access operators is outdated and does not reflect the true cost of running open access services on the network. However, care should be taken that any new charging regime does not serve to disincentivise operators considering introducing new services. I would expect a more detailed discussion with the ORR once the MVA report on competition has been published.

Q30 What are your views on the proposals to improve incentives to reduce traction electricity consumption?

It is my view that currently the ORR and the industry should focus at this point in time on developing and rolling out the systems which are necessary to capture the actual costs of energy and the losses on the network. It is therefore a premature step to look to introduce economic levers such as charges before we are able to fully understand the issues.

While I would not discount a charge of some description at some point in the future, in a system where track and train are working more closely, and are incentivised in such a way as to be mutually dependant on each others performance, more efficient use of energy should evolve organically.

Q31 Should we put a cap on certain freight charges in advance of our determination and should these be linked to other changes?

While I understand the benefits that a cap on freight charges may have on business planning, the same could be said for passenger operations. In line with some of the conclusions in the RVfM, care must be taken not to unnecessarily constrain income streams where the freight market can bear this, particularly where this supports the reduction of subsidy requirements.

Notwithstanding the above, there is not a compelling body of evidence within the consultation which would sway my view on this either way, and I would therefore expect a more detailed discussion with the ORR on this issue.

Q32 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'?

While a phased approach would appear the most sensible approach, I would need to examine this in the context of the timing of our next contract for passenger services and the provisions contained therein. Therefore this is an issue which I would look to explore with the ORR in detail as the periodic review develops.