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Dear Richard

Direct Rail Services (DRS) is pleased to respond to the ORR's December 2011 Incentives consultation document. DRS appreciates the importance of this periodic review, particularly in the current climate of industry change and efficiency savings. DRS do not have any issues with this content being published on the ORR website.

Summary

DRS will support any reasonably sound incentives proposals to improve the efficiency of the railways which would bring benefit to the passenger and freight fraternity and its customers.

We do have concerns that the alliances, bespoke arrangements, changes to schedule four and eight, devolution to the routes and disaggregation of costs to the routes has the potential to increase administrative staff/costs and this would be a perverse outcome.

For many freight traffic flows profits are already marginal.

It should not be lost on the ORR/NWR that we are in a competitive market in which we are competing with each other as well as the road hauliers.

Questions

Q3.1: Do you agree that in PR13 we should focus on incentivising delivery of outcomes that customers, wider society and funders value?

Yes

Q3.2: Do you agree with our assessment of the outcomes that customers and society value?

Yes, as long as the outcomes and outputs are realistic, credible and achievable

Q3.3: How do you see the trade-offs between and within the interests of customers, funders and society? How do you see the trade-offs between current and future customers, funders and society?

A balance has to be struck by the decisions that industry as a whole makes now and the impact that this may have on the future growth of the railways.

To this end the ORR will have a vital role to play

Q3.4: To what extent do you think we should measure and monitor the delivery of those outcomes and outputs we incentivise? What metrics should we use? To what extent is it practical and desirable to monitor delivery of outcomes at the local level? ORR should agree a review process as part of setting the outcomes/outputs in order to ensure that the incentives stay deliverable and effective. Quite often it will be at local level that delivery might be failing and local level staff (industry wide) needs to be able to identify and deal with.

Q3.5: What do you see as the key enablers for Network Rail's successful delivery of outcomes in CP5? How should we best measure Network Rail's performance against these enablers? How should we best incentivise these? It is through people at all levels within NWR that the key enablers identified will be delivered. Devolution in particular will be a massive culture change to NWR and proper training and understanding of incentives, outcomes/outputs and the consequence of failure should be an incentive.

Q3.6: What do you see as the key features of the transmission mechanism? How do Network Rail's customers respond to changes in Network Rail's behaviour and how does this translate into the experience of end-customers and society? How should we take this into account in the design and implementation of our incentives? As 3.4 and 3.5 above.

Q3.7: How do you think industry reform would affect the transmission mechanism? How do you think changes to franchise agreements would affect the transmission mechanism? Linked to the last three questions industry reform/change if not dealt with properly will affect the transmission mechanism which could potentially be to the detriment of the customer(s). To this end NWR must be clearly focused and incentivised to the delivery of its outcomes/outputs.

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? If the efficiency sharing benefits both the operator and NWR on lower cost solutions without affecting quality then this would be a sensible arrangement however, the question above reads "incentives on train operators to work with Network Rail to reduce its costs?"

Q4.2: What are your views on our proposed design of a route-based efficiency sharing mechanism, as described in this chapter 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? The existing efficiency benefit mechanism has not yet benefitted any of the operators, our performance has still to be confirmed, imagine this ten times over?

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?

Bespoke arrangements suggest separate agreements between NWR and various operators which could place some operators at a commercial disadvantage. It may work with bespoke groups.

Q4.4 What are your views on our assessment of potential impacts of a route-based efficiency sharing mechanism, as described in this chapter and in Annex B?

Cross routes have more potential to underperform whilst other routes have more capability to outperform and with the cross route operators potentially dealing with various routes this will surely lead to additional perverse administrative costs.

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?

The current detail available up to now has proved to be insufficient and inaccurate. Further analysis on market trends and operators ability to contribute to NWR fixed costs needs to be on going.

Q5.1: Do you think that the current possessions and performance regime broadly help to align incentives between operators and Network Rail in the best interest of customers, funders and society? If not, why not?

Overall we believe that schedule four and eight works well for all parties.

Q5.2: Do you think it is appropriate to retain Schedules 4 and 8 as liquidated sums compensation regimes?

For planned possessions (Schedule 4) DRS realised a significant improvement in our ability to offer an alternative solution if there is a major disruption (Cat 3) as we now have the ability to claim for the cost related with the alternative arrangement. This mechanism is vital to be preserved.

Minor disruption events (Cat 1 and 2) pay towards increased cost of the operation and are helpful when ensuring commercial robustness of the services (we cannot recover these additional costs from the customers)

For Schedule 8 – cancellation and variation charges as above.

For 3rd party penalties DRS would consider other than LD approach – although the current

system is quite fair and DRS have learnt to minimise our exposure (i.e. there is a good incentive for the FOC to minimise 3rd party delays)

Q5.3 Do you think it would benefit customers, funders and society and encourage greater co-operation if Schedule 8 compensation rates from Network Rail to train operators did not reflect the full impact of possessions on revenue and costs? We also welcome any further views on this issue in relation to Schedule 4.

This may well work for passenger operators under bespoke arrangements.

We feel that further analysis is needed as to the alignment of this incentive to freight especially given that NWR is currently in breach of condition 1 of its licence with regards to operational performance.

Q5.4: Do you think existing incentives are as effective as they can be in ensuring that Network Rail and train operators perform at a level that is economically and socially optimal, and whether they sufficiently drive Network Rail behaviour? In particular, we invite views on whether we should place further incentives on Network Rail to ensure it fully takes into consideration the impact of service disruption on passengers, i.e. disruption above that already reflected in Schedules 4 and 8 compensation payments for loss of fare revenue, and how we could go about doing this.

This would seem to be a question aimed at passenger operators however if a passenger service runs at certain times of the day or evening because of a franchise agreement in which very few people travel then this would appear to be uneconomical but could be socially important but not optimal.

As to freight the answer would have to be no and would refer to the answer in 5.3 above

Q5.5: Do you envisage any barriers to modifying or replacing the Schedule 4 and 8 regimes in cases where both a train operator and Network Rail wish to? What do you see as the advantages and disadvantages of bespoke approaches? Do you agree with our proposal regarding the circumstances when we will approve bespoke Schedule 4 and 8 arrangements?

The majority of the industry would appear to favour the existing schedule 4 and eight arrangements however, as previously stated the bespoke arrangements would probably fit easier with passenger operators as opposed to freight operators at this current time.

Q6.1: In what circumstances do you think bespoke charging arrangements are likely to occur? What advantages and disadvantages could such arrangements have? How might they work for or against the alignment of incentives?

Operators of high value/profile traffic flows with detriment to not so high value/profile flows both operationally and commercially.

Q6.2: What protection do you think might be needed for third parties not included in the scope of a bespoke arrangement?

We believe that if the scope of any bespoke arrangements had the ability to impact on any third party contractual agreements that this would render the bespoke arrangement as perverse.

Q6.3 Do you agree that it would be helpful for us to set out a set of principles on the basis of which we would decide whether to approve bespoke arrangements? Do you have any views

on what those principles should be?

As or similar to 6.2 above.

Q6.4 How do you think we should treat bespoke charging arrangements that might span Network Rail control periods or change within control periods?

If the bespoke arrangement was in effect a contract? Then you would expect it to run for a period of time and if the control period stays the same?

Q7.1: What are your views, additional to those set out in your response to our May consultation, on our treatment of the following options:

(a) The scope of our proposed review of the volume incentive, including disaggregation by Network Rail route and consideration of a down side as well as an upside?

We support the volume incentive which should align with the industry prediction of freight growth. Need more detail of how NWR would see disaggregation working over the routes.

(b) That we continue to support the rationale for the capacity charge, and will support Network Rail in its work to revisit and recalibrate the charge for PR13?

The capacity charge for PR13 is currently being consulted to the industry and hopefully will be agreed and set before this time, incentive?

(c) That we should establish the extent to which infrastructure capacity is under-utilised before proceeding to develop one or more indicator by which to monitor capacity utilisation?

For freight, capacity utilisation has to be able to consider realistic end to end journey times. The current situation of operational performance that NWR finds itself in could have a bearing on future capacity.

Q7.2: What are your views, additional to those already expressed in your response to our May consultation, on the policy we are considering further to levy a charge to incentivise better use of capacity?

This could adversely affect the smaller, newer or poorer operator's access to the network at times required to meet their business demands and the status quo should remain.

Q8.1: Do you agree with the criteria that we have applied in assessing different options to Network Rail's cost of capital and our approach to its financial structure?

Q8.2 Do you agree that we should use a cost of capital for Network Rail that reflects the risks faced by the business, even though this may not reflect the company's actual financing costs?

Q8.3: How do you think we should deal with the surplus cash that results from such an approach?

Q8.4: What advantages and disadvantages do you see in our regulating Network Rail in a way that preserves the options for changes to the company's financial structure?

Q8.5: How should we strike the right balance between the interests of current customers and funders and future customers and funders?

No comment to 8.1, 2, 3, and 4, 8.5 ensure stability and cost effectiveness of the industry.

Q9.1: How do the incentive properties of our different treatments of different classes of expenditure affect operating decisions on the ground, e.g. is it the potential financial gain or loss that motivates actions or are decisions more based on other factors such as relative complexity, cultural factors (e.g. tradition or professionalism) or the nature of Network Rail's financing and governance arrangements?

Q9.2: Are the incentives on Network Rail affected by the different ways we may assess support, operations and maintenance costs, compared to renewals and enhancements expenditure? In particular, we may use a base year for support costs that is rolled forward by an efficiency assumption, whereas for renewals we will probably not roll forward a base year but will take a view on the likely level of expenditure in each year on a pre-efficient basis¹²⁷ and then apply an efficiency assumption

Q9.3: Do you expect Network Rail's work on whole-life costs to change its decision-making, and in what way?

Q9.4: Is there any evidence of „capex bias“ at Network Rail?¹²⁸ To what extent is this undesirable?

Q9.5: Should we seek to equalise the incentives for different types of income and expenditure? How best might we do this?

No comment on 9.1-9.5

Q10.1: Do you agree with our overall proposed approach to incentivising innovation? If not, what do you propose we do instead?

Yes, key to reducing costs.

Q10.2: What merit do you think there would be an innovation fund? How should such a fund work? How would we guard against „crowding out“ and ensure the fund did not displace existing expenditure?

Would be a cost to managing it and could become politically contentious.

Q10.3: What merit do you think there would be in an innovation prize? How should such a prize work? Who should be eligible to enter? What sort of prize would best stimulate genuine innovation?

Yes, encourage innovation, industry associated bodies, prize aligned to innovation.

Q10.4: In relation to the use of output KPIs, what KPIs do you think we should target and why? Should we monitor them only or should they have some incentive attached to them and if so what?

No comment.

Q10.5: Do you think that KPIs should be introduced for companies other than Network Rail to monitor innovation across the wider industry?

No comment.

Q10.6 Beyond any comments that you may have made to us in response to our May consultation, do you have any comments on our overall approach to environmental incentives? Specifically, do you think we should introduce other environmental incentives beyond those that we are proposing? Do you think we should go further in encouraging the rail industry to improve its environmental performance even if this resulted in a shift to other modes?

Environmental improvements and performance can often equate to more costs and when the industry tries to recover these costs customers vote with their feet and as such could not support measures which lead to modal shift.

Q10. 7 We are keen for the industry to propose methodologies for monitoring emissions and producing improved whole-life, whole-industry business cases. What role do you think the ORR should play in this process?

Over and above what the ORR does now, in conjunction with the DFT closely monitor any EU directives/legislation which can impact on the UK railway industry.

Yours sincerely

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