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Dear Richard

Periodic Review 2013 – Consultation on incentives

Introduction

Thank you for the opportunity to comment upon the ORR's current thinking on the way that incentives may be used in the PR13 periodic review. This letter draws together the response of FirstGroup and all of its rail operations: First ScotRail, First TransPennine Express, First Capital Connect, First Great Western and Hull Trains.

FirstGroup welcomes a review of incentives built into the industry contractual regime. As the McNulty Rail Value for Money (RVfM) report concluded, it is clear that a lack of aligned incentives between Network Rail (NR) and operators in several areas prevents the industry from maximising its revenues or optimising cost efficiency. This view has been reinforced both by the work undertaken by NR and TOCs / FOCs as part of the Rail Delivery Group's (RDG) review of opportunities for cost savings in asset, programme and supply chain management and from the initiatives identified from the introduction of "alliances" with NR Routes.

Incentives for efficiency improvement

Our view is that there is a substantial opportunity to drive both cost savings and improved customer outputs from closer co-operation between operators and NR. However, for this engagement to be effective there has to be a reason for the TOC or FOC to want to try to help NR manage its costs – as your consultation highlights the operators currently are largely insulated from NR's cost efficiency.

The national efficiency benefit share (EBS) mechanism introduced in CP4 would have been a step in the right direction if its effect had not been largely neutralised by the decision for it to be part of the franchise Sch 9 adjustment back to DfT. However, even if that hadn't happened, the difference in scale between NR and even the larger operators created an imbalance, so that an individual operator could not be sure there would be a direct relationship between actions taken locally and improved efficiency for NR at a national level, weakening the incentive to devote significant effort in this area.

Devolution of decision making around operations, maintenance and renewals (OMR) to the 10 NR Routes addresses this imbalance. Accounting for efficiency at a Route level, supported by the proposed Regional EBS, means that operators would see a more direct benefit from local efficiency initiatives. Also, with more of a balance in size of operation to that of the local Route(s), operators would hope to be able to influence decisions more and be able to engage meaningfully with their local Routes to agree approaches to efficiency which suit the local requirements.

However, we believe that the clearer the link is between the actions taken by the

TOC and a share in any resultant cost efficiency the better. For this reason we believe that bi-lateral agreements are likely to be the most effective route to improving efficiency – either on individual initiatives or as a Route level Alliance. It is encouraging to see that the current proposals view bi-lateral agreements as sitting alongside the Regional EBS or even replacing it for TOCs in Alliances.

We do wish to see appropriate safeguards in place so that minority operators on Routes can also benefit from a share in the regional EBS even if there is an alliance by the Route with the dominant operator. We also need to make sure minority operators are not disadvantaged through perverse behaviours arising from bilateral arrangements which could align the Route's interests too much with one operator, such as occurred with some of the bespoke provisions in the CP1 track access agreements.

The proposal to include a downside risk share in what is going to be a mandatory regional EBS scheme is not one we support, despite understanding the perceived advantages set out in the consultation. There are three main reasons for opposing the downside risk share:

- The lack of a financial track record of costs or an understanding of how the different cost drivers apply at the NR route level to form a reliable baseline to measure efficiency from in CP5. This is exacerbated by the unclear basis of allocation of NR central costs to route level, with no local influence on controlling those central costs;
- The introduction of exposure to regulatory risk where we do not have direct control to address the outcomes. This would apply to the level of ambition in the efficiency targets set by ORR as to whether the targets are achievable for the Route; and to the exposure to changes in standards as to what NR may be required to meet (eg the increased activity following Hatfield on guage corner cracking);
- A lack of clarity as to the way in which bi-lateral agreements or alliances will interact with regional EBS, particularly around the risk that the most fruitful opportunities for cost saving may be addressed outside the regional EBS leaving the minority operators being targeted on helping the Route deliver efficiencies in less obvious areas, possibly with the Route's attention focused on the bi-lateral initiatives. It needs to be made clear as to whether there will be a hierarchy between the various approaches to aligned incentives or will the NR share of the savings achieved within the alliance / bi-laterals still feed into the regional EBS, so that other operators are incentivised to assist with achieving alliance efficiency schemes.

We are willing to take on downside risk share as part of b-laterals or alliances where we believe that we will be able to negotiate greater control over having some ability to manage those risks and in clearly setting out the parameters around what is or is not in scope for the risk share.

On the other proposal to expose operators to changes in NR's fixed costs at Control Period reviews, we would need to see more detail on how it would work before we could assess whether the potential benefits would outweigh the risks. For this to be workable there would need to be a clear distinction between the areas of cost that TOCs / FOCs could influence from the issues outside our control. Operators would also need reassurance that they would not be exposed to changes in fixed costs arising from changes in how NR is to be funded such as has happened at previous CP reviews or cost increases from external changes in the asset standards to be met by NR. How any savings or increased costs would be shared between the operators

and funders and any caps on operators' risk exposure would need to be clearly identified.

Schedule 4 & 8 incentives
Of the existing incentive regimes, these two are the most important to operators. There remains a clear need for these to continue to provide a liquidated sums compensation regime based on the impact of poor performance or possessions upon TOC revenues and costs. In a franchise bidding context the presence of an effective compensation regime enables bidders to take a high level approach of broadly assuming that changes in the levels of possessions or performance do not need to be directly modeled in the passenger revenue line, so avoiding the need to build in a risk premium into bids for the risk of increased disruption.

We do not think that there is evidence that TOCs are not incentivised to push NR for improved performance by the level of Sch 8 receipts, as seems to be the implication of the idea that there would be greater co-operation if compensation levels were to be reduced. Other parts of the ORR responsible for monitoring performance should be aware of the significant effort put in by TOCs to get improved Joint Performance Improvement Plans (JPIPs) that push NR for improved infrastructure and network performance, with detailed development of joint initiatives. Also several of our TOCs have requested ORR to investigate and if necessary take enforcement action against NR where there has been sustained underperformance against the JPIP – not something that reflects an acceptance of underperformance due to the compensation provided.

It has been suggested by some stakeholders that Sch 8 is inefficient or overly complex – we do not agree and view Sch 8 as an essential way of financially incentivising both NR and operators to improve operating performance. The area which can be inefficient is the process of delay attribution which has developed into a confrontational process between NR and the TOCs of trying to allocate delays to the other party. The objective of delay attribution is important in ensuring that root causes are identified and addressed, so we hope that the closer co-operation between the parties introduced by Alliances can find a way for the attribution process to be performed jointly without the man marking of the current approach.

Overall we think it important that there are no fundamental changes to Sch 4 & 8 even with the move to EBS, bi-lateral agreements or alliances. They provide clear financial incentives around possessions and disruptions to service which are reasonably well understood, forming a framework upon which further agreements for driving improved outputs or greater efficiency can be developed.

We would support the need for a review of the calibration of these regimes to ensure there is a sound relationship between the rates and the revenue / cost impacts. We would also want to ensure that benchmarks are set appropriately and aligned to the performance objectives of NR. For example the ORR has stated that NR is likely to be in breach of its licence with regards to punctuality on high speed services, yet Schedule 8 flows do not reflect this. We would welcome a recalibration of the regime in terms of NR benchmarks, payment rates and monitoring point weightings.

For Sch 4 we would question whether the Sustained Planned Disruption (SPD) threshold has been set at the right level. The enabling criteria are currently set at a level where they are almost never met, despite sustained periods of disruption which generate losses and costs not captured by the Sch

4 formulae. This needs to be addressed to provide NR with a reason to seek to minimise the impact on the affected operators and to provide a reasonable incentive to the TOC to willingly cooperate with NR to help develop efficient access planning on major projects. To date this effect has been largely neutralised by 18.1 / Sch 9 adjustments funded by DfT, but will be a real concern to new franchises.

The other element of Sch 4 we would want reviewed is the risk that the time periods for the discount factors can drive inefficient behaviours, in that currently it encourages NR to book possessions as early as possible, before the actual work content has been designed. This necessarily leads to contingency being built in to the possessions resulting in train services being restricted more than they need to, reducing industry revenue. The incentive regime needs to work to incentivise NR to make the most effective use of the restrictions they request.

Capacity utilisation incentives

We are unclear if everyone in the industry understands what "capacity" means and this leads to differing views as to the way forward. Should NR be incentivised to produce more paths or faster paths or should they facilitate longer trains? Do we wish predictability to the customer and provider, in terms of times, frequency and duration of services or do we wish the timetable to be more dynamic? There is trade off between available track capacity, performance improvement and journey time benefits. These need to be understood incentives aligned to the preferred outcome.

It is not clear what the Industry is aiming for in terms of capacity and the overall use of it. This question may become even more difficult to resolve if specification and purchase of services becomes more devolved.

There is a danger that any significant new incentive here may point the future use of a part of the network away from its customers. A mixed use network is going to have to absorb line capacity dis-benefits to enable optimum use by a variety of customers.

We re-iterate our views that path auctioning should not take place and that path allocation should be made on the current well understood administrative basis, with clear criteria that take into account societal benefits as well as monetary ones.

As indicated for Sch 4 & 8, we would recommend that there isn't any significant change in the basis of the underlying charging mechanism for CP5. Following the RVfM study and NR devolution to the Route based structure the industry is going to be trying to develop new, more aligned approaches to driving up efficiency. We think that this is best done against a background of charges and incentives that the parties already know and understand rather than have to redesign these bi-lateral or multi-lateral approaches at the start of CP5 due to a fundamental change in access charges and incentives. Accordingly, we welcome the confirmation that ORR is not minded to introduce Revenue Sharing or Reservation Charging as part of PR13.

Whilst the Volume Incentive and Capacity Charge are not necessarily as effective as they could be, they do provide NR with an incentive / protection to encourage them to accommodate requests for more train paths. There have been concerns that the

Volume Incentive in particular was too remote (ie paid centrally and deferred until the next control period) from the people making decisions about capacity to influence behaviour. We support the proposed change to move this incentive down to a route level as a step towards making it a stronger incentive to support growth.

We welcome the indication given in the consultation that ORR are not minded to take forward either TOC revenue sharing or Reservation charges as new ways in which to make NR more incentivised in creating additional paths for operators – both seemed to be complex approaches where it was not clear that the possible benefits would outweigh the disadvantages. In particular the revenue share seemed to be trying to get NR to do things they already were funded to do or suggest that they could allocate paths on the basis of a commercial arrangement when the control of allocation of any paths created seems a separate regulated activity.

We note that ORR are still pursuing the idea of scarcity charges, with the proposed route seeming to be changing the track access charge to reflect the opportunity cost of the infrastructure / time of day used by the path. Whilst we can appreciate the theoretical attractiveness of path based charging, we again do not see the need to completely throw up the basis of charging for track access for the whole network to address an issue of how to allocate a small number of paths, mainly on the intercity lines, where there are conflicting aspirations for the paths. Given that even under the proposed "flexibility" of the new Train Service Requirement (TSR) in new franchises the government seems to still want to specify nearly all of the franchised service outputs, with no flexibility to reduce the service in a downturn, most passenger operators will still not be operating in a "market" based system. Accordingly, a move to using market based methods to charge and allocate paths seems likely to just either increase the costs for funder specified services or skew the rail market to the types of service that generate the highest revenue ignoring wider social and economic factors.

Whilst we understand that decisions in this area are connected to your review of on-rail competition, we do not see sufficient reason to move to path based charging at this stage.

Other issues in consultation

Bespoke charges – we do not see a particular need for bespoke charges, beyond what has been put in place to incentivise modifications to rolling stock to reduce their impact on track maintenance costs or to allow for third party funding of infrastructure. However, we support the approach of retaining the flexibility for NR and operators to agree bespoke charges as part of identifying collaborative solutions to particular issues, as long as the ORR approves these new charges and ensures that they are not discriminatory. It would be helpful for ORR to set out the principles against which they would assess any proposed departure from the regulated charges.

Network Rail financing – this is primarily an issue for the funders of NR to address, although the need for NR to be adequately funded for both its current activities and investments for the future is essential for the rail industry. We would reiterate our views that introducing unsupported debt or even equity into NR at this stage would act against the current willingness of NR to consider and push forward with structural changes such as Devolution and alliancing, in order to give contractual certainty to external financiers. There will no doubt be a role for external investment in managing the infrastructure in the future, but we suggest that the industry should change its structures first and build up a track record of performance based on the devolved Route based structure, before going to the market to attract funding.

NR cost of capital – we are unsure as to why NR requires a higher cost of capital than its cost of funding, unless there is a likelihood that NR is going to seek to attract external debt funding during the control period. This higher funding cost, effectively building up a reserve for contingencies, seems to increase the perceived cost of rail higher than necessary given the government backed funding it currently is able to access.

NR capex bias vs opex – our TOCs do perceive there to be a bias towards capex investment rather than operating costs in how NR approaches how to meet its output objectives. This may in part be down to the way of accounting for RAB funded expenditure on an amortised rather than expenditure basis. However, it also extends to NR's desire to identify infrastructure solutions (within its control) to delivering HLOS outputs such as capacity schemes, rather than considering if there might be an operational or rolling stock solution first. This issue is one that NR is making efforts to address and there are signs that the increased joint development of proposals in the IIP (and also the RDG review of projects expenditure) is leading to a more balanced approach which should give a better VfM solution in future.

Incentivising innovation – we think that the best approach to incentivising innovation is to provide access for developments which are unlikely to be taken forward by any one organization on its own, either because the benefits would not pay back in sufficient time or that the issue needs cross industry input to deliver. Any such funding would have to guard against "crowding out" of ideas that would be developed anyway. We do not support the alternative suggestion of introducing specific KPIs for innovation, which is always going to be somewhat subjective but also will bias innovation efforts into what can be measured against the KPI, not a wider view of developing new thinking.

Please do not hesitate to contact me if you would wish to discuss any of the points raised in this response in more detail.

Yours sincerely

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