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Wednesday, 8 February 2012

Dear Richard

Network Rail's Response to ORR's 'Incentives' Consultation

ORR's first PR13 consultation in May 2011 came at an interesting time given it followed so shortly after the publication of the Rail Value for Money Study's Final report. These are again significant times for the GB rail industry with the eagerly awaited DfT Command Paper due to be published early this year, and a swathe of refranchising also coming up.

We recognise and support the need to tackle head-on the value for money challenge. It is clear that the way forward needs to be all about getting industry players working together better. The Rail Delivery Group is, perhaps, the most high-profile example of the full commitment that the industry has to an even more successful railway that can deliver the country's aims for it.

Network Rail for its part is in the process of re-focussing the clarity of its message so that there can be no confusion, internally or externally, as to our purpose, mission and vision. A clearer 'line of sight' to these three high-level statements will anchor all of our corporate divisions and businesses to consistent goals. The reason we are doing this now is that we are undertaking a stretching programme of change. We are becoming a much more devolved and more focussed 'group' of undertakings than has been the case before. In addition to our plans for delivering on our CP4 commitments, we are focussed on key enablers for longer term transformation including through devolution, alliancing, change in the way we manage projects, investment in information systems and culture change.

Network Rail, therefore, welcomes the opportunity to comment on ORR's second PR13 consultation. We also found the industry workshop on 9 January, which ORR organised, to be very helpful. There are a large number of topics covered in the 14 December document and as requested we have framed our views and input around ORR's specific questions.

Because of the necessarily wide range of topics covered by this consultation, we thought it worthwhile to set out a smaller number of high-level observations in this letter.

Aligned Incentives

Network Rail strongly supports the desire to better align train operators' and our own incentives. The major industry stakeholders have already demonstrated their willingness to co-operate more effectively through the formation of the Rail Delivery Group. It is, therefore, important that ORR does not lose sight of this aim in moving into the detailed design of charges and other incentive mechanisms. It would be unfortunate if discussions shifted away from consideration of how the incentive framework can help train operators and Network Rail to support each other in driving mutually beneficial change towards a more negative consideration of how train operators can 'bear down on' Network Rail's cost base. It would seem to us to be a backward step to envisage such a confrontational set of relationships when we have an opportunity to achieve real improvement through better alignment.

Output-based Regulation

ORR helpfully raises the issue of trade-offs. We consider that this is an area where considerable progress could be made in CP5 to the benefit of the whole industry.

At the moment there is a danger that Network Rail will be deemed to have 'failed' CP4 if it does not hit every one of its many outputs and targets. The argument could go that if we outperformed our financial settlement but missed one operational target we should have spent some (or all) of that out-performance rectifying the missed target. However, this is to miss the point that spending lots of extra money on hitting that last elusive output could be very poor value for money indeed.

The more targets Network Rail is set the more 'brittle' the determination will be to difficulties and the more expensive the financial allowance that will be needed to hit them all. If trade-offs are encouraged during the control period this is likely to deliver best value for money. We recognise that there would need to be considerable transparency about how tradeoffs are made and we are keen to explore this further with ORR.

A specific targeting issue relates to Network Rail's use of management excellence metrics. These are valuable tools which have historically assisted Network Rail in improving its management capabilities and are contributing towards increased cost efficiency and improved outcomes. We consider that excellence metrics have a function in helping to measure progress by the company.

There is a potentially important role for ORR to understand excellence models relating to key competences for the business. In particular this can provide an additional source of heuristic challenge for the business itself. In a regulatory context, it can therefore facilitate an aspirational business-led dialogue with the company in relation to key enablers of longer term improvement. However, caution is required in using this approach to set rigid targets for particular metrics since a degree of flexibility is required to allow detailed plans to develop in response to emerging information. By contrast, where excellence models are used to develop longer term improvement plans it may be more useful for the company to be held to account for delivering the plan rather than a particular level of excellence as defined by such models.

Network Rail's cost of finance

ORR has devoted quite a large part of its consultation to considering whether it should change the way in which we are financed. In particular ORR discusses the impact of moving its assessment of our cost of capital away from the regulatory norm of it being based on the full risks faced by the business to one based on a forecast of its cost of debt.

This is an important issue and we fully understand the desire of funders to get best value for money. However, we consider that ORR should not overlook the lack of any precedent for its idea for a cost of debt approach. We address the precedent and State Aid issues in a separate letter with an accompanying report from OXERA.

Network Rail currently 'recycles' the equity component of our cost of capital back into the industry through the ring-fenced fund and through reinvestment of outperformance. A change to a cost of debt approach would merely make CP5 cheaper to fund at the expense of longer-term cost increases to funders from higher debt. We would need to borrow more today at the expense of higher interest in the future. If this is a key objective then consideration should be given to the appropriate timing of cash flows and potentially prepayment of an element of debt/RAB without compromising the basic model.

We also believe that consistency is important in respect of the approach to our cost of capital. If, for example, a cost of debt approach was adopted in CP5 before reverting to a conventional approach in later control periods, this would serve to undermine the stability of the regulatory regime in the eyes of the external market, particularly rating agencies and investors. This could, in itself, increase the cost of financing debt. A supportive regulatory regime that demonstrates its commitment in practice to output-based regulation is also important for the rating agencies.

In summary, we do not support moving to a cost of debt approach. Maintaining the existing approach is also consistent with our plans for transforming Network Rail into a group of more distinct business units, promoting competition where appropriate and potentially letting long term concessions where this can add value.

Regional Efficiency Benefit Sharing

ORR includes some helpful analysis to illustrate its arguments with regards to the potential introduction of a ‘one-size fits all’ regional efficiency benefit sharing mechanism.

However, Network Rail maintains that a bespoke approach is more likely to lead to optimal outcomes. Indeed it was one of the key observations of Sir Roy McNulty’s RVfM study that industry solutions should be ‘horses for courses’ and not uniform.

Nonetheless, we are happy to work with the industry on the most appropriate design for a standard framework if that is ORR’s final decision on the basis that this then provides a better starting point for more bespoke arrangements where necessary. In considering that design we consider that it should be symmetric so as to create a genuine partnership with train operators and ourselves. We also consider it should be broadly defined, so as to avoid any perverse incentives from trading costs and outcomes for items that are beyond its scope.

Separate price controls

It seems likely that CP5 will include 10 separate determinations of some network outputs and funding – one for each of our recently devolved Operating Routes. However, we strongly consider that for the English and Welsh routes the determinations should not ossify separate route based RABs and it should not restrict our ability to manage risk in a transparent way across routes. In particular, out-performance (or under-performance) would be transparent but would not be hypothecated to each route. Network Rail remains a single company and in order to efficiently manage its affairs in the interests of taxpayers and rail users, it will need to have the ability to transfer out and under-performance around the network.

We consider that it is appropriate that we retain the one-company entity whilst adopting local delivery – we see this as the best of both worlds.

Simplicity

Our final key point is a plea for simplicity. Running a train business is technically challenging as it is without the added burden of complex rules and mechanisms which, whilst well-intentioned, can be confusing or create unintended consequences.

CP5 should, in our view, be structured to have simple charges (including geographically uniform variable usage charges). There will, of course, be swings and roundabouts in the micro-detail. However, we consider that charges are better if they are ‘approximately right’ rather than ‘precisely wrong’. The improved alignment of interests will not come by introducing ‘improvements’ in the cost reflectivity of charges but from sharing of outperformance and risk against baseline projections.

Next Steps

The issues covered by this consultation are fundamental to the future of the business and the interests of our customers, funders, taxpayers and rail users. We look forward to engaging further in debating them with ORR and other industry stakeholders in the forthcoming months.

Yours sincerely

Peter Swattridge
Head of Regulatory Economics