ATOC

ASSOCIATION *of* TRAIN OPERATING COMPANIES

Richard Owen
The Office of Rail Regulation
One Kemble Street
London WC2B 4AN

10th February 2012

Dear Richard

ATOC response on ORR incentives consultation

The publication of the ORR's consultation on a range of incentives in Control Period 5 provides a further opportunity to promote the co-ordination, alignment of the GB rail industry is to deliver the outcomes required by passengers, funders and wider stakeholders. This consultation is ambitious in its coverage and poses a number of important questions that need to be considered in the context of the policy and strategic developments that are currently taking place following the publication of the McNulty report and the expected direction of travel following the forthcoming Command Paper. ATOC's response is structured to address the high-level themes of the consultation and points out the main areas on which we believe the ORR should focus in taking the process forward.

The industry is working together through the Rail Delivery Group to drive forward reform. The forthcoming Command Paper will set out the Secretary of State's strategic priorities and direction for the rail industry. Considerable progress has already been made in setting out the context and strategic direction for the industry. A successful Periodic Review remains a key component in supporting reform that will deliver a cost-effective, responsive outcome: our view remains that the emphasis of the ORR must continue to focus on Network Rail's outputs and efficiency in the first instance. ORR can certainly play an important role in facilitating industry parties to work more closely together but also needs to be ready with regulatory interventions, if necessary, to any correct potential abuses of monopoly position. One cannot necessarily replace the other.

Each industry party has a role to play in delivering an efficient outcome that delivers the requirements of passengers and funders. The ORR's central responsibility is to ensure that Network Rail's delivery of its regulatory outputs is facilitated, monitored and enforced, recognising that both franchised and open access train operators compete both for and within the market, which drives efficiency through the operation of competitive discipline.

In addition to any change to the incentive framework, we believe that it is essential that the priorities, activity and capability of the ORR in fulfilling this task are transparent to stakeholders. This does not simply imply operating the periodic review process competently but also through appropriate and timely regulatory engagement with NR that supports the ability of train operators to deliver to their customers.

Outcomes

ATOC agrees strongly that the industry needs to focus on the outcomes required by passengers and funders, and that the regulatory and contractual architecture must be designed to facilitate this. For franchised train operators, outcomes are largely specified at a high level through the contractual relationship that funders have with franchised operators. They specify the level, quality and priorities for train service provision. We believe that the regulatory and incentive regime therefore works best when it supports TOCs and NR to fulfill passenger and funder expectations, and must be focused on ensuring that industry processes are well-aligned and focused delivering outcomes to passengers and funders. As the DfT and other funders will continue to specify what they require franchises to provide, efficient outcomes are promoted when there is clear alignment between the funders and the ORR, and where there is certainty as to the priorities facing the industry.

Changes to incentive regimes and governance must be designed to improve the delivery of outcomes and simplifying and aligning the delivery of industry outputs. Periodic Review 2013 must ensure that there is clarity over the specific outputs required from Network Rail to support the delivery of train services in areas such as capacity, journey times, performance, network capability and traction electricity. The rail industry's contractual framework means that operators rely very much on ORR to set these specific outputs, both through the periodic review process and through the approval and enforcement of track access agreements.

As we set out earlier, the industry is already responding to the challenges of the McNulty study through the RDG, as well as through the outcomes set out in the Initial Industry Plan. Network Rail devolution is already well advanced, and the DfT and Transport Scotland are developing future franchise policy. The industry is moving forward together, and future regulatory and incentive structures must recognise and support the actions of parties who are committed to delivering the required outcomes. While reviewing the effectiveness and appropriateness of the current framework is necessary, in our view introducing further change must have a clear financial or behavioural benefits: there are opportunity costs involved in implementing changes to 'the rules', and the ORR must ensure that its proposals are based around delivering the right outcomes for train operators, users and stakeholders and that the incentive structure is optimised within the whole-industry output context.

ATOC believes that the bar for considering whether to make further changes beyond those being prepared in response to the challenges posed by McNulty is high.

Industry reform and transmission mechanisms

Train operators have welcomed Network Rail's devolution and the intention for it to be much closer to end-users. NR is increasingly focused on meeting the needs of train operators, who are its principal customers. The design of NR's regulated outputs for PR13 is critical to ensuring that there is clarity as to what it is required to deliver, and that these reflect the needs of operators who are the principal customer-facing parties in the industry. ATOC draws attention to the emerging alliances between train operators and NR , recognising that they may result in requirements to modify and develop transmission mechanisms in the light of changes to relationships between industry parties.

NR's regulated outputs should be straightforward, monitored and designed to support further evolution of the industry structure. By 2019, there may be further changes required to interfaces and management arrangements to support growth, the development of alliances and other strategic priorities. The ORR therefore needs to design the regulatory framework to be responsive to industry change and support ongoing reform. The transmission mechanism must recognise that there are existing statutory and organisational boundaries, but its operation must support flexibility, innovation and efficiency, and ensure that the the appropriate party is properly incentivised to lead and benefit from efficiency gains. Any changes to the incentive structure must reflect and support emerging industry reform rather than limit and define the process. Industry parties should be empowered to deliver high quality, value for money outcomes for passengers and taxpayers.

At present, we consider that there are areas where the transmission mechanism is not either visible or understood in terms of how it assists in delivering outcomes, for example the volume incentive. We believe that the incentive structure going forward must reflect both the overall objectives of the rail industry and the key requirements of train operators with respect to delivery of their contracted outputs.

Route-based efficiency sharing

Train operators have been working closely with the DfT & ORR to develop proposals that provide effective incentives on industry parties to work closely together to deliver efficient outputs, particularly REBS. These need to be considered in the context of wider industry financial arrangements to ensure that the appropriate outcomes are delivered. The consultation sets out options that provide the basis for a standardised arrangement that encourages operators and Network Rail to work much more closely together, while supporting the development of alliances and much closer collaboration across the industry.

We believe strongly that there will be additional benefits derived through bespoke arrangements between Network Rail and operators, building on current and future alliancing, and that the default mechanisms set out in the consultation, whilst a useful basis upon which efficiency can be promoted and shared across the rail industry, should be adapted over time as bespoke arrangements are agreed. The default mechanisms need to be transparent, simple and quick to implement, to ensure that bidders for future franchises are clear about both the opportunities and risks that they may incur, and to ensure that the overall outcome delivers value to all parties. There need to be clear governance arrangements and regulatory principles put in place that provide confidence to all parties that there is clarity as to the scope, definition and distribution of efficiency shares. The ORR must be able to demonstrate to both train operators and NR that it has the resource and competency to monitor and enforce efficiency sharing, and that the arrangements put in place do not disadvantage train operators who are not closely-aligned to one specific NR route or where there are specific alliancing arrangements agreed, ensuring that current arrangements that protect the interests of national, secondary and open access passenger and freight operators are retained and reinforced where necessary.

For efficiency sharing to work in practice all parties must be confident that there is a genuinely more efficient outcome rather than spend being deferred, and that there are reliable mechanisms in place for such assessments. If there is no such mechanism, or ambiguity as to how it will applied, ATOC's judgement is that it will hinder, not enhance, the development of incentives. Efficiency sharing can deliver significant incentive properties, but needs to be credible, predictable and protect the interests of all operators.

Performance regimes

Performance management arrangements are currently well-understood and we believe generally drive appropriate behaviours across the industry. We do not believe that there is strong supporting evidence either for lagging Schedule 8 payments, which are calibrated using industry-standard processes, or for only partially compensating operators for the revenue effects of disruption. The performance regime is designed to reflect the actual impact on passengers, so we consider that there may be further opportunities to research through new fieldwork whether a kinked Schedule 8 curve may reflect lower marginal revenue gains at relatively high levels of operational performance.

We also recognise that there are opportunities for bespoke performance management to be put in place in parts of the network, and that these can be facilitated through ensuring that the default incentives regime continues to be understood and straightforward.

The current performance regimes, part of track access agreements between train operators and NR, are designed to incentivise all parties to deliver efficient engineering access and to minimise delays caused to passengers. They are based on clear principles:

- Assisting franchise bidding and driving value by removing the need to forecast and take risk on NR performance and network availability when forecasting revenue during the franchise bidding process;

- Reflecting long-term revenue loss from poor performance or loss of network availability;

- Are (largely) no fault in nature, through the operation of a liquidated damages regime; and

- Giving incentives to NR to plan possessions well in advance so that operators can make appropriate arrangements, in a timely fashion.

We believe that these remain good principles and therefore should continue to form the basis of performance regimes unless there is a clear case to the contrary. Train operators are not persuaded of the need for significant change to the existing policy framework for a number of reasons, although they do fully accept the need for recalibration and setting of new benchmarks is an essential process for the start of CP5.

Current arrangements have a strong alignment with Network Rail routes and train operating companies. As with any systematised model, there will be areas at the margins where improvements in calibration will deliver closer alignment with actual revenue effects, but train operators do not consider that there is overall misalignment in the current process and that the structure is any more biased to ‘overcompensation’ than it is to ‘undercompensation’. Schedules 4 and 8 are designed to incentivise NR and compensate operators where appropriate, recognising that the impacts of possessions and delays are key to the customer experience.

Train operators note the proposal to review the societal rate as part of the recalibration of the performance regime. but are conscious that this is an area that has already been introduced and withdrawn from the access process, apparently without any major effects on performance. This is possibly because reputational issues play a very strong role here both on NR and with TOCs, not least in the case of the latter the widespread perception that a TOC that operates a route not achieving PPM targets will be marked down in the procurement process for new contracts and possibly not even be short-listed for this reason.

Access charges

Any change to the setting or structure of track access charges needs to be evidence-based, and to be consistent with the Access and Management Regulations. Therefore train operators consider that the application of more complex or significantly restructured arrangements is likely to be limited to areas either where there is significant investment taking place or where industry structures have changed. Any bespoke arrangements will need to reflect other parties’ access rights and the wider charging principles, not least non-discrimination. We consider that where there is competition for capacity on a route that the usage charge should reflect the fixed and overhead costs of providing those paths to provide a better signal to operators and Network Rail.

We recognise and welcome the development of separate price controls by NR route, building on the separation between Scotland and England/Wales introduced in the current Control

Period. As many train services cross NR route boundaries, the structure of charges needs to be simple, transparent and cost-effective in its operation. We consider that the ORR needs to ensure that the framework in which NR implements charging is as transparent as possible, for example building on the already-existing work that disaggregates costs by NR route.

Given the long life of infrastructure investments, there needs to be a straightforward default mechanism in place whereby they can be funded across the duration of Control Periods. Given that enhancements are already treated separately to renewals and maintenance within efficiency assessments, as with efficiency sharing the ORR needs to ensure that the incentive properties are aligned with normal commercial decision-making, as the current five-year length of Control Periods may not encourage appropriate behaviour from industry parties.

Simple, predictable charging supports industry planning and business development. Maintaining and refining the present regime can support the delivery of effective outcomes.

Capacity utilisation incentives

Train operators support the continued deployment of the volume incentive, recognising that it needs to be disaggregated in order to align with the impact of demand by operating route. The function of the incentive must be to provide a stronger incentive to NR to provide additional capability where there is demand, supporting wider industry planning processes to deliver effective solutions that may not necessarily result in infrastructure interventions. The ORR needs to ensure that the operation of the volume incentive is effective in incentivising NR behaviours and that there is a clear transmission mechanism that ensures affordable and timely enhancements.

The management of network capacity is critical to delivering a cost-effective industry, but at the same time operators look for clarity and simplicity in the structure of charging. The experience over the past decade is that capacity questions have been best resolved through painstaking timetabling work through the industry's planning process, most notably the comprehensive RUS process, and that it has been possible to find substantial extra capacity on busy routes through detailed, collaborative working between NR, passenger and freight operators. We remain unpersuaded that a theoretically-efficient structure of charging would on its own drive more appropriate outcomes, for example where train service outputs are hard-wired into franchise agreements, and the ORR must consider its approach in a wider context and with regard to the priorities and outputs required by passengers, funders and other stakeholders.

There may be a case for exploring the potential for moving towards a value-based charging regime, however, on intercity routes where clear economic benefit can be demonstrated.

Train operators remain concerned that the proposals set out in May 2011 to review and potentially increase the number of individual charging elements may not reflect the commercial or contractual framework that they face going forward. Additional complexity in the charging regime, for example through capacity or reservation charges, will not substitute or materially enhance the framework for strategic capacity planning, especially in the context of specified service outputs and the requirement to accommodate the reasonable requirements of diverse train operators. This is particularly important in the context of route-based price controls.

Any further complex proposals are unlikely to change behaviours or improve the wider planning process – therefore operators remain opposed to additional charging categories.

Network Rail's financing arrangements

The consultation document sets out a number of issues relating to the capital structure and incentives faced by Network Rail. The long-term sustainability of the rail industry is vital to the development of train operators' businesses and to delivery of better services to passengers, and it is clearly important to ensure that NR is both incentivised to deliver more efficiently while being funded to provide stability and not jeopardise contracted or regulatory outputs. NR is unusual in being regulated at the intermediate stage of production, rather than being principally focused on the end-user, as well as not being accountable to shareholders.

Decisions on the future ownership and control of NR are rightly matters for government. We believe that the success of its regulatory and incentive regime, irrespective of ownership, is determined by the extent to which incentives are aligned through the industry and are reflected in Network Rail's licence, management structure and corporate incentivisation. Strong stewardship of the network is essential and train operators therefore believe that the ORR is right to raise issues around the equitable distribution of costs and funding between current and future operators. There is good reason, given current uncertainty about the availability and cost of capital, to ensure that structures put in place are flexible and capable of evolution in the light of external developments going forward, not least the long term dynamic of public expenditure.

The incentive properties of opex and capex cost recovery

The consultation raises issues as to whether NR is currently biased in favour of capital expenditure rather than seeking solutions that do not increase its asset base. This was identified as a potential issue by the McNulty study and is a well-recognised issue with the standard economic regulatory framework. To some extent this is at risk of being magnified in the case of rail by the strong separation that funders apply between public expenditure on capital from expenditure on revenue support.

It is already being addressed through the RDG and the alignments promoted through devolution although it should be noted that most ideas for reducing the intensity of capital spend that are typically put forward often require policymakers to address challenging tradeoffs on revenue account such as higher fares, reductions in lightly used services and increases in crowding. Whole-industry planning and solution identification is already significantly improved through the RUS and Planning Oversight Group processes, and at this stage, given the volume of other initiatives under way, there appears to be a requirement to monitor and support change without introducing further complexity into the incentives regime.

The industry reform processes already under way provide a focus on optimal outcomes – there is at present no clear-cut case for reviewing any remaining bias towards capital solutions.

Other incentives

The consultation document considers whether incentives can support improved innovation and environmental performance in the industry. Train operators do not consider that either of these necessarily areas are appropriate for ORR intervention.

Innovation should generally be encouraged through normal commercial relationships, where a business case can be developed, and the direction of industry reform is designed to facilitate this. In some cases, however, the complex system of the railway will be best served by cross-industry funding arrangements that encourage and support collaboration to deliver affordable and sustainable innovations.

Ensuring that the governance structures for all cross-industry funds facilitate innovation is a priority and we look to the ORR to support this. This is more important to the industry than the establishment of KPIs by the ORR for innovation, particularly with respect to companies which are not subject to economic regulation, appears to be a further promotion of bureaucracy and complexity without a strong evidence-base in support – and fundamentally against the direction being promoted by the Government with respect to removing or not imposing further controls on what are commercial businesses.

Train operators are subject to environmental legislation covering a wide range of operational activities. They are also subject to strong competitive pressures to reduce energy consumption (and therefore emissions) and reputational incentives to demonstrate they remain ahead of other modes and their competitors when it comes to franchise bidding. There is both a compliance and business requirement for good environmental performance and it is difficult to envisage how the ORR can add value through the establishment of further regulatory measures in this area.

Working closely across the industry, operators are therefore seeking to continually improve rail's relative environmental performance. As part of this operators have been working with NR and ORR to improve understanding of energy consumption and reporting and it is expected this will continue as proposals to disaggregate elements of NR and TOC costs (including energy costs) at route level are developed. In this context there is no case for setting targets for TOC environmental performance although the value of regular reporting is supported. Where TOCs are reliant upon NR for improved performance, for example reducing losses from the distribution of traction electricity, we do support targets to incentivise NR performance in an area where there is no clear transmission mechanism to support optimal whole-industry outcomes.

We continue to support incentivisation of on-train metering – recognising that there are benefits across the industry from more accurate disaggregated information on energy use, and recognising that in some cases franchise terms may not have sufficient time remaining to provide a robust business case.

More broadly, it is important that the incentive effects of broader industry reform are given a chance to work through properly before new or additional environmental measures are contemplated. Longer franchises and the transfer of responsibilities at stations are designed to place the right incentives on operators to invest in environmental improvements.

Conclusion

Train operators recognise the importance of a strong incentivisation of the rail industry to provide the right outcomes for passengers, funders and stakeholders. The role of the ORR is key in ensuring that Network Rail has clear, deliverable outputs to support these outcomes. There are areas of the existing framework that will benefit from review or recalibration, but in our view there is some way to go to make a case that some of the changes discussed in the consultation document have material benefits and do not increase either the burden or complexity of regulatory engagement in the industry, and that the ORR is capable and competent of monitoring and using the incentives framework to the benefit of train operators and their customers.

Yours sincerely

Alec McTavish
Director, Policy & Regulation
Tel: 020 7841 8006/07767 642916