FINAL

Consultation Response

ORR Consultation on Incentives

PR13

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1. Introduction

1.1. ***pteg*** represents the six Passenger Transport Executives (PTEs) in England which between them serve more than eleven million people in Tyne and Wear ('Nexus'), West Yorkshire ('Metro'), South Yorkshire, Greater Manchester, Merseyside ('Merseytravel') and the West Midlands ('Centro'). Leicester City Council, Nottingham City Council, Transport for London (TfL) and Strathclyde Partnership for Transport (SPT) are associate members of ***pteg***, though this response does not represent their views. The PTEs plan, procure, provide and promote public transport in some of Britain's largest city regions, with the aim of providing integrated public transport networks accessible to all.

1.2. ***pteg*** welcomes the chance to input into the PR13 process and respond to this consultation.

2. Summary of key points

2.1. PTEs are seeking a greater devolved role in the delivery of local rail services, which would mean a much direct responsibility for the specification and funding of passenger franchises.

2.2. We broadly agree with the objectives set out by the ORR for PR13. However, local rail services in PTE areas generate substantial wider social and economic benefits, which are not always taken into account in existing incentive mechanisms. We would therefore see merit in considering the inclusion of these wider benefits, for example, in the calculation of Schedule 8 payments, and, potentially, in the PPM regime.

2.3. The PTEs would like to have a better understanding of Network Rail's cost drivers at a much greater level of disaggregation than is currently the case. While we welcome the ORR's proposals to implement incentives at a NR route level, we feel that this does not go far enough in many respects.

2.4. We feel the calculation of the fixed access charge lacks transparency and a robust allocation methodology between different types of track and service. Without tackling this issue it will be difficult to achieve a meaningful alignment between the incentives faced by TOCs, sponsors and NR.

2.5. For example, while we understand the potential value of TOCs becoming more exposed to Network Rail's costs at periodic reviews, for this to be effective we feel there is a need for improving the transparency and disaggregation of NR's cost structure.

2.6. We also have concerns that the proposed efficiency sharing mechanism could become yet another cumbersome and opaque industry process, adding complexity and transaction costs without necessarily leading to improved alignment of incentives. We do see some potential in the context of specific jointly promoted schemes. However, this would require a clear framework to be set by the ORR and much greater cost transparency and disaggregation.

2.7. We strongly agree with the principle that any bespoke charges should be based on objective, transparent and well founded evidence and would argue that this should be the over-riding objective that an assessment of bespoke arrangements should concentrate on.

2.8. We strongly agree that there needs to be a mechanism for capacity charges to recognise the potential congestion impact of specific enhancements and changes in operational and would strongly support the ORR in implementing this proposal.

2.9. We agree that, if the capacity charge is maintained for the next control period, then payment rates and marginal revenue effects should be reviewed.

2.10. We are sceptical of the value of the current Volume Incentive or the potential value of a reservation charge, scarcity charge or an additional variable charge aimed at improved capacity utilization.

3. Context

3.1. PTEs are seeking a greater devolved role in the delivery of local rail services in the West Midlands and North of England, and discussions are currently underway between the PTEs and the DfT on this issue. The McNulty review identified potential benefits relating to devolved funding, specification and management of local rail services and ***pteg*** will be looking for the PR13 process to facilitate this wherever possible.

3.2. **Devolution** would probably mean a much more substantial role for PTEs in the specification, development and funding of passenger franchises. The PTEs are also considering what the most appropriate risk allocation is likely to be and whether to propose to take more direct control over station management and operations. In a devolved scenario, we would indirectly become Network Rail's main client in our areas, both through subsidy payments to TOCs and in the case of capital investments. As such we have an extremely keen interest in reducing rail industry whole-life costs, but also in delivering growth and passenger satisfaction. Our ability to hold Network Rail to account and get the most value for money out of the railways will be influenced by the industry framework as it emerges from the PR13 process.

3.3. Despite our objective to deliver efficiencies and growth, local rail services in PTE areas and their hinterland will in the future continue to require significant amounts of public subsidy to operate. This is justified by their significant contribution to the **wider social and economic wellbeing** of the areas they serve. A general issue for the PR13 process will be to recognise that the subsidised nature of PTE area rail services could drive industry behaviours which do not entirely recognise these wider socio-economic benefits (in particular non-user benefits, e.g., congestion reduction, and wider economic benefits) and could therefore lead to a sub-optimal allocation of resources.

3.4. One key problem stems from the fact that such socio-economic benefits often significantly outweigh the direct farebox revenue from local commuter services, whereas this is unlikely to be the case for long distance services. It is worth pointing out that the unit decongestion benefits from commuter services travelling into the centre of large cities at peak times are at least an order of magnitude greater than those arising from inter-city services largely travelling through less congested areas[1].

3.5. More generally, we do not feel that the existing **charging methodology** and underlying evidence base always accurately reflect the costs directly incurred by different types of operator and service. In that sense, we feel they can provide weak, and in some cases perverse, incentives to TOCs, Network Rail and public sector sponsors. This is of particular concern in a devolved context, where the DfT would no longer be able to fully internalise

[1] See the WebTAG decongestion unit. Some PTEs have derived their own estimates of decongestion benefits based on local traffic mix, which, in some cases, reaches figures as high as 50p/trip-km. Note that according to the McNulty review, revenue per passenger-km on regional railways is around 8p/pass-km.

existing weaknesses in the charging regime. For example, it seems difficult to understand why fixed access charges for passenger services, which are assumed to be largely invariant with volume, speed and type of traffic, can represent 10 times more income to Network Rail than variable access charges[2]. In a future scenario where all the existing DfT grant could conceivably be routed through access charges this disparity could increase even further.

3.6. Without a more robust methodology for understanding, allocating and charging for NR's so-called fixed costs it will be difficult to achieve a meaningful alignment between the incentives faced by TOCs, sponsors and NR. To play the role of a more informed local client we would need to gain a much better understanding of Network Rail's costs and outputs at a disaggregate level than is currently the case.

3.7. At the same time, a substantial amount of industry effort goes towards understanding, calculating and negotiating **overly complex charges**, the robustness and incentive value of which we would dispute (for example, the capacity charge and Schedule 8 payments to TOCs, which provide no financial incentive to Network Rail on the need for investment). We recognise that there is value in some of the proposals in the consultation document, which could go some way towards addressing our concerns. However, we need to stress the importance for ORR to assess *a priori* what overarching industry objectives a specific approach to charging is likely to meet and weigh those up against implementation costs. We acknowledge that this involves a subtle and challenging trade-off in some cases and are keen to support the ORR in its evaluation of specific proposals wherever helpful.

4. PR13 Objectives (chapter 3)

4.1. ***pteg*** agrees that in PR13 the ORR should focus on incentivising the outcomes that customers, wider society and funders value and we also broadly agree with your assessment of what these outcomes are likely to be (passenger and freight customer satisfaction, economic growth, connectivity, environmental sustainability).

4.2. However, we feel it needs to be recognised that industry stakeholders will often value different types of passenger in different ways and that this may differ from the implicit valuation made by public funders and society at large. For example, TOCs will typically stand to gain more from carrying one passenger for 50 miles in the off-peak than several passengers on a 5 mile stretch in the morning peak[3]. However, providing good rail accessibility to congested urban employment centres from surrounding suburban areas at peak times can have a greater value to the economy and society at large than a longer distance link between less congested areas[4]. This is a particular issue in the highly subsidised PTE franchises where there is little commercial incentive on a TOC to grow its customer base, and indeed where attracting additional peak passengers often has a greater impact on costs than on revenue.

4.3. In addition, it is clear in the DfT's economic appraisal framework that the impact of public expenditure on non-users (in terms of congestion, accidents, emissions and wider economic benefits) should be taken into account in the assessment of government expenditure. Indeed, this is often critical in demonstrating the need for public funding of transport networks. While the impact on non-users are implicitly recognised in your reference to

[2] ORR consultation, table 6.1, p.74
[3] Largely due to the impact on load factors.
[4] See the WebTAG unit on decongestion benefits and, for example, the Northern Hub Phase I Economic Analysis report.

economic growth and environmental sustainability, and are generally included in rail investment appraisal, we feel that this issue needs to be at the core of the industry's decision making, including for example the allocation of capacity and other processes that require a degree of prioritisation between competing users.

4.4. ***pteg*** recognises, of course, that there are trade-offs between the interests of customers, public sectors funders and society at large (including tax-payers). But it is precisely for this reason that we argue that the wider social and economic impacts of rail services need to be more explicitly acknowledged and articulated so that the distribution of full social costs and benefits is better understood by all. The PTEs are keen to work with ORR, Network Rail, ATOC, DfT and other key stakeholders to improve the way in which the wider social and economic benefits of rail are addressed and to ensure they are embedded within the industry's decision making processes.

4.5. With respect to the **monitoring and delivery of outputs and outcomes**, we believe that in order to take account of the social and economic functions of different rail services, and to enable devolved authorities to perform their role in a meaningful and effective way, this needs to be done at the most disaggregate level practicable. This could be, for example, individual PTEs and their hinterland or, even below that, individual corridors. Although we are not in a position to estimate the cost to the regulator and industry stakeholders of obtaining and analysing this detailed level of information, we would point out that TOCs are already able to provide highly disaggregate and accurate estimates of passenger demand, crowding , revenue and costs using industry standard methods and tools at minimum cost. We would also argue that having a reasonably disaggregate knowledge of a business can be critical in identifying, prioritising and delivering efficiencies and cost savings.

4.6. That being said, we would note that the setting of specific outputs need to be carefully weighed up against each other and wider objectives to avoid Network Rail narrowly focusing on one target at the expense of wider objectives (the trade off between safety, with the target of avoiding any incidents whatsoever[5], and delivering value for money across the business as a whole is a case in point).

4.7. With respect to the **transmission mechanism**, and building on our point in paragraph 2.5, we would argue that the balance of Network Rail funding that comes through the direct grant and from fixed, variable and other access charges could be made to provide a stronger set of financial incentives to Network Rail than is currently the case. We would argue that this balance needs to be set so as to reflect the wider social and economic objectives that one intends to achieve.

4.8. At the same time, we would note that, in a future devolved context, fixed, variable and other access charges could also provide a strong signal to those bodies involved in specifying and funding rail services. However, it is difficult to see this happening with the substantial weight currently given to fixed access charges and the lack of transparency in their calculation. A similar problem exists with capacity charges, where the broad brush and static mechanism currently in place does not encourage the delivery of schemes which may actually increase

[5] Note the recent decision by NR's senior management to decline its entire bonus payment for the current year as a result of a number of fatalities at level crossings. It's also worth noting the ramping up of infrastructure and TOC operating costs in the years that followed the Hatfield and Potters Bar crashes.

capacity and have a positive knock-on effect on congestion (a point further developed in the response from Centro).

4.9. In our view, it should be a main regulatory function of ORR to establish a sound and robust relationship between NR's cost base and the charges applied to its customers. While this has been achieved to some extent with the variable and electric traction charges, we feel that the fixed charge as currently derived is symptomatic of the lack of transparency with respect to rail infrastructure costs.

4.10. We acknowledge that there is a fine balance between accuracy and complexity in setting the structure of track access charges. However, we feel that there is little point in having a highly sophisticated mechanism for estimating variable and capacity charges when fixed charges are treated as a lump sum bearing no relation to rail outputs. It is worth comparing the UK track access charge structure with, for example, those in France and Germany, which despite their relative simplicity, lead to much greater price differentiation between types of route (core/feeder), path (prime/low cost) and service type (fast/slow) than is the case in the UK, and therefore send a strong, clear signal to funders and operators.

5. Aligning Network Rail and train operators incentives to increase efficiency (chapter 4)

5.1. As pointed out above, ***pteg*** recognises some deficiencies in the current mechanisms available to incentivise operators and Network Rail to behave in the most efficient way. At present, this works in both ways in that TOCs are un-affected by changes to access charges, and similarly Network Rail has very limited scope for directly charging for expenditure which improve a TOC's operational efficiency.

5.2. Although we appreciate the underlying rationale for a route-level **efficiency sharing mechanism** we feel there is a risk that, if applied by default at an aggregate level, this could become yet another cumbersome and opaque industry process, adding complexity and transaction costs without necessarily leading to improved alignment of incentives. We are particularly concerned by the possibility that this could lead to windfall gains for individual TOCs, based on spurious high level assumptions which bear no direct relation to underlying, operating-level, cost drivers.

5.3. Moreover, we have concerns that TOCs would have a financial incentive to support, or even encourage, NR to reduce network capability, without consideration for the long term wider social and economic consequences of those actions. In this context, it is important to recognise that both the TOCs' and Network Rail's management are evaluated and rewarded on much shorter timescales than the 60 year appraisal periods over which rail investment is typically appraised.

5.4. Where we do see some potential value in this mechanism is in the context of specific jointly promoted schemes where the action of one party has a direct and demonstrable bearing on the costs and revenues of the other party. While we accept that this would require some form of bespoke arrangement on a case by case basis, we cannot see this working without a clear framework and detailed guidance, which would need to be set by the ORR. In support of our view, we would highlight that at present there's a very significant asymmetry of power and information between NR, TOCs and local funders (i.e.: PTEs), with the balance tipped in favour of NR. Without a step change in the level of disaggregation and transparency in

Network Rail's cost basis it would be very difficult to implement a robust efficiency benefit sharing system.

5.5. With respect to the appropriate spatial level at which such a system should operate, we feel this clearly needs to go below the route level and ideally concentrate on individual corridors and stations, which is where specific targeted action by TOCs and funders could be demonstrably linked to changes in infrastructure costs.

5.6. In respect to the proposal that **TOCs' become more exposed to Network Rail's costs at periodic reviews**, this would seem to be a very powerful incentive for TOCs to behave efficiently, to engage more closely with NR and to scrutinize NR's cost base. It also seems fair that a proportion of infrastructure cost increases or savings gets passed directly on to customers. In that sense, it is difficult to disagree with the principle on which this proposal is based.

5.7. On the other hand, however, we would expect an individual TOC to have only a relatively marginal, and fairly localised, impact on NR's cost base. It also needs to be remembered that NR is a monopolist and that TOCs do not have access to usual free market mechanisms for disciplining NR (i.e.: going to a different supplier). Given this and the lack of transparency and disaggregation of Network Rail's cost drivers it seems somewhat optimistic to expect a TOC to consider worth investing any significant amount of time and effort to reduce a cost structure they do not necessarily understand and which they could only ever hope to have a marginal impact on. This point has a strong link with our earlier comments on the transmission mechanism and the need for greater clarity on infrastructure cost drivers and, in turn, ensuring this is accurately reflected in the network access charge mechanism. At present, fixed charges represent over 80% of payments to NR for an operator such as Northern. Effectively, the signal this sends to the TOC is that there is little it can do change the vast majority of NR's costs.

5.8. We would also expect a significant risk of free-riding (both with respect to sharing of costs and efficiency) which, again, could probably only be addressed through greater transparency and disaggregation of infrastructure (and operating) costs.

5.9. Overall, we see a very significant role for the ORR, in the context of this proposal, in improving the transparency and disaggregation of NR's cost structure and in developing robust methodologies and empirical research to identify key infrastructure cost drivers.

5.10. Another important issue in the context of this proposal is the likely impact on the **risk premium** built into franchise bids. We are pleased that the ORR recognises this issue (paragraph 4.47 of the consultation document) but would add that this would be of particular concern in a devolved context where relatively financially constrained public bodies may be required to take on a substantial amount of risk which currently lies directly or indirectly with central government. We would therefore like to see a more detailed analysis of the implications of this proposal for franchise bids, of how the proposed mitigation mechanisms might work and of the expected impact on infrastructure costs. This could then form the basis for a more rational assessment of whether the benefits from this proposal would outweigh its costs.

5.11. We note that the ORR is proposing for changes to the cost of **enhancements** to be excluded from the proposed mechanism. While we acknowledge there are sound reasons for why this should be the case, we would also note that this is one type of expenditure where the actions of individual TOCs can have a direct bearing on costs, for example, where TOCs willingness to operate a revised timetable or to divert services via an alternative route (which may all have a cost) could significantly reduce construction costs and timescales. We therefore feel this would be worth further consideration.

6. Access charges (c. 6)

6.1. ***pteg*** broadly agrees with the charging objectives set out in paragraph 6.9 of the consultation document, and in particular with the following:

- Be consistent with the wider objectives of funders;
- Incentivise NR, TOCs, train manufacturers, ROSCOs and funders to ensure the efficient utilisation and development of the network and the optimisation of whole industry costs;
- Be practical, cost effective, comprehensive and objective in operation;
- Reflect the efficient costs caused by use of the infrastructure;
- Ensure that charges enable NR to recover but not to over recover, its allowed revenue requirement.

6.2. We would also wish to point out that the PTEs are one of the funders of the rail network and may see this role enhanced in the future in a potentially devolved context. As such, the charging objectives should be consistent with our own wider objectives as well as those of DfT and other funders.

6.3. Earlier in our response, we have set out our concerns that some elements of the charging regime are not necessarily consistent with these objectives. In particular, we have argued that the fixed access charge (which makes out the majority of payments from TOCs to NR), in its current form, does not necessarily reflect the costs caused by use of infrastructure for a given operator or service and, as such, provides a relatively weak incentive to “ensure efficient utilisation and development of the network and the optimisation of whole industry costs”.

6.4. At the same time, we appreciate that there may be difficult trade-offs between different objectives and accept that it is the ORR’s role, in consultation with industry, to identify the most appropriate balance between these.

6.5. With respect to the proposed arrangements surrounding the setting of **bespoke charges**, while we are generally content with the broad principle set out in the consultation response, we agree with the ORR’s assessment in paragraph 6.27 that past experience shows this could give rise to significant transaction costs, could lack transparency and could result in arbitrary variations that lacked rationale. We therefore welcome the ORR’s determination to avoid these issues in the future.

6.6. We strongly agree with the principle that any bespoke charges should be based on **objective, transparent and well founded evidence** and would argue that this should be the over-riding objective that an assessment of bespoke arrangements should concentrate on. However, we would note our earlier concerns regarding the level of transparency, disaggregation and cost reflectiveness of existing infrastructure cost information and would call on the ORR to address this issue. In our view this would be critical not only in enabling an informed and equitable negotiation between NR and the TOC seeking a bespoke arrangement but also in protecting any third parties that may be affected.

6.7. With respect to the remaining principles set out in paragraph 6.29, it seems clear that, while track wear and tear costs are a sound basis on which to allocate direct maintenance and renewals costs, the ORR should remain open-minded about alternative methods that could be used in the context of different types of intervention. One example would be the reconfiguration of services to improve performance (as set out in paragraph 6.24 of the consultation document) whereby a detailed analysis of timetable and operational data would be required to assess the impact on congestion and track capacity. Paragraph 6.25 refers to **station charges** and, given the PTEs strong interest in this area, we would welcome a more detailed discussion with the ORR and NR on the principles that should apply in this context.

6.8. With respect to the treatment of **bespoke arrangements proposed between periodic reviews or which span control periods**, it would seem to defeat part of the objective of such arrangements (deliver efficiencies, align incentives, promote innovation) if ORR were to insist on approving them only as part of periodic reviews. In our view, ORR should deal with such requests on a responsive basis while ensuring that they were consistent with the approved charging objectives and structure, and had no adverse effect on third parties. We feel it would probably be more difficult to implement any bespoke arrangements that had a material effect on third parties outside periodic reviews. Certainly in a devolved context PTEs would find it difficult to mitigate for the regulatory risk linked to unexpected changes in access charges, within a control period, resulting from bespoke arrangements they were not party to.

7. Possessions and performance regime (chapter 5) and capacity utilization incentives (chapter 7)

7.1. Given the relationship between capacity charge payments to NR and schedule 8 (performance regime) payments from NR to TOCs we address chapter 5 and 7 of the consultation jointly.

7.2. We feel it is useful to start by summarising our interpretation of the role of different types of payment and their relationship to ensure we have a correct understanding of their rationale and method of implementation:

- Schedule 4 possessions regime is paid out to TOCs by NR to compensate for planned restrictions of use (RoU) which may have a negative impact on TOCs' short and long run revenues. It is calculated on a formula basis and is supported by behavioural research into passenger preferences.
- Schedule 8 applies when there is unplanned disruption, such as when train services are late or cancelled, and can be paid by NR to TOCs or vice-versa subject to an attribution process. The amount payable is established on a formula basis and is equally supported by behavioural research into passenger preferences. Schedule 8 requires delays to be attributed to individual TOCs and NR, a process which is understood to generate significant transaction costs.
- PPM (Public Performance Measure): % trains that reach their final destination within a certain margin. NR has a special responsibility to lead the performance improvement process so that target levels of PPM are achieved and hence this is one of the key incentives for NR to improve network performance. TOCs are incentivised to perform well through the impact on fare revenue and reputation. However, we would note that externalities (as opposed to farebox implications) are excluded from the analysis..

- A Capacity Charge (CC) applies as a uniform payment per train-km separately estimated by geographical area and broad time period based on statistical analysis of past data, revealing the correlation between increased traffic and network delays. The control total charges under the capacity charge equals the amount paid out by NR to TOCs in sch. 8 payments. NR then essentially pays out the amount received from the capacity charge on the basis of actual disruptions.

7.3. Below we set out some initial observations on the incentive properties of these different payment/compensation regimes:

- If one operator runs an additional service through a given area and this leads to a more than proportional increase in delays, then the capacity charge would be expected to increase for all operators at the next point the charge is re-estimated. If delays were to increase proportionally to traffic then the unit capacity charge would be expected to remain constant.
- If delays increase in a given area (with traffic constant) then it would be expected for the capacity charge to increase for all TOCs operating in that area at the next point the charge is re-estimated. This seems to leave no financial incentive (apart from PPM) for NR to improve performance and may actually lead to perverse accounting incentives whereby NR could increase its revenue over time purely by letting performance slip.
- It's unclear whether the amount paid out in capacity charges in a given area matches the amount distributed by NR in Schedule 8 payments. It is our understanding from initial discussions with the ORR that this analysis has not been undertaken. One would expect, given the underlying statistical analysis of the correlation between delays and traffic, for the two figures to broadly match at the point when the relationship is initially estimated. However, this may change over time, especially if investment in improved network performance is effective in reducing delays. In such a scenario, it is conceivable that TOCs in one area end up cross-subsidising TOCs which operate in a different area.

7.4. Based on the points above, we would agree that both the Capacity Charge and Schedule 8 payments provide signals to TOCs regarding the impact of changes in traffic on congestion. In addition, Schedule 8 also performs a compensation function in the context of franchise agreements where TOCs take revenue risk. The extent to which they are effective and cost reflective will depend, amongst other things, on the quality of the underlying data, the degree of disaggregation in the charge and the impact on congestion of intervening enhancements and operational changes. We are therefore in agreement with the proposal in paragraph 5.21 of the consultation document that, if the capacity charge is maintained for the next control period, then payment rates and marginal revenue effects should be reviewed.

7.5. On a related note, we have previously argued (and this is further explored in Centro's response) that there needs to be a mechanism for capacity charges to recognise the potential congestion impact of specific enhancements and changes in operational performance. We are therefore pleased to see that this is addressed in paragraphs 6.24 and 7.47 of the consultation document and would strongly support the ORR in implementing this proposal.

7.6. On the other hand, it seems clear that the Capacity Charge and Schedule 8 do not provide any form of incentive (asides perhaps from reputational) to Network Rail given that an increase in Schedule 8 payments would result in an equivalent increase in the quantum of capacity charges. The incentive for NR to provide additional capacity operates through the

PPM regime though we would note that this does not necessarily reflect capacity or schedule 8 payments. In that sense there seems to be a disconnect between the incentives faced by NR and TOCs when it comes to capacity and we would query whether a simpler yet better aligned charge structure may not provide a more efficient outcome at a lower cost.

7.7. Paragraph 5.29 of the consultation document puts forward the possibility that NR could be set penalties to be paid to public funders for failing to meet service quality targets. While a sensible proposal in principle, and reasonably common across other types of transport franchise/concession, it seems difficult to implement in practice in this context given that public funders ultimately subsidise NR.

7.8. We note that schedules 4 and 8 (and hence capacity charges) both attempt to reflect the financial implications for operators of network disruptions. For heavily subsidised commuter services commercial revenue may be significantly outweighed by the **wider socio-economic value** of services. Hence, charges that focus exclusively on financial implications of disruption are likely to introduce a distortionary effect in the decisions of TOCs and funders. This issue is recognised in paragraphs 5.27-5.28, where it is mentioned that in CP2 schedule 8 included a societal rate payable to DfT. Although this was eventually dropped due to the added complexity, we would argue that under a devolved context with multiple funders and competition for scarce capacity between commercial and subsidised operators there would be merit in giving such a mechanism further consideration. We would be interested in understanding how this mechanism worked previously to develop our ideas in this area.

7.9. The existing **PPM regime** could equally be improved in principle by giving greater consideration to the wider socio-economic value of different services. However, we appreciate that there are certain advantages of the current system (in particular, its simplicity and good understanding amongst industry stakeholders) which may advise against such a move.

7.10. With respect to the **Volume Incentive**, we see some advantages in principle in disaggregating this further but believe that this needs to go below route level for it to be of any value in our discussions with NR. Nevertheless, we are not convinced that this incentive has driven any particular change in behaviour by NR, and therefore question its value. NR is not a private company whose shareholders would stand to gain from a financial incentive. The NR's Management Incentive Plan[6] (MIP) does include a 'Long Term Incentive'[7] but we would expect this to be more easily attained by reducing costs than focusing on the Volume Incentive, at least at its current level. We would therefore be interested to understand how the ORR decides on the level of the Volume Incentive, and hence on the optimum balance between cost savings and traffic growth.

7.11. With respect to the idea of a **Reservation Charge**, we agree with the views of the ORR set out in paragraph 7.57 of the consultation document that this is likely to be an expensive response to a relatively minor problem.

7.12. With respect to the proposal to undertake further work on a possible **Scarcity Charge**, which reflects the true opportunity cost of a given use of the infrastructure, we agree that this has

[6] http://www.networkrail.co.uk/browse%20documents/regulatory%20documents/regulatory%20compliance%20and%20reporting/management%20incentive%20plan%20statement/mip%202009-10%20statement%20final%20(25%20june%202009).pdf

[7] Based on the gap between actual income and expenditure and the target set by the regulator over a three year period.

obvious appeal from a theoretical point of view. However, we cannot see how such a concept could be applied in practice in an economically efficient yet cost effective way. The literature in this area[8] suggests that an auctioning process would be required to assess the true value of a given path or set of paths. Yet, it seems entirely impracticable to do this for a network the size of Great Britain. We also fail to see how this could be merged into the timetabling process, which poses significant challenges of its own without the added complication.

7.13. With respect to the related proposal to set an **additional variable charge** aimed at incentivising capacity utilisation, we have serious concerns that this could merely replicate the known weaknesses of the capacity charge and add even more complexity to the process. We would also be interested to understand how it would relate to the capacity charge, to ensure TOCs aren't being over-charged, and how it would relate to the fixed charge (presuming that this new charge would be used to fund enhancements to increase track capability in the spirit of long run marginal cost).

8. Network Rail's financing arrangements (chapter 8)

8.1. In our view, there are two separate issues to contend with in this part of the consultation document:

- Firstly, would government prefer for Network Rail to finance some of its costs in the commercial markets rather than through government debt?
- Secondly, what approach should the regulator take to calculating Network Rail's cost of capital?

8.2. The first question is clearly for government to answer. From where we stand, this is asking whether government would prefer to keep the borrowing costs of the railways down or whether it prefers to use public funds (which can be raised at a lower cost) in other policy areas. Given the wider socio-economic value of rail services (in particular local commuter services) then we would argue this should be a priority area for public expenditure.

8.3. Moreover, we would argue that since central government is implicitly taking the risk on a default by Network Rail anyway (as evidenced by the move of Railtrack back into public ownership) it seems irrational to increase borrowing costs artificially or to speak about the "*risks faced by the business*" as if these were any different from the risks faced by Network Rail at present.

8.4. With respect to the second question, our understanding is that the key regulatory purpose of determining the cost of capital is to set the allowed revenue requirement for a private sector monopoly utility provider. At present, government decides on the appropriate level of public debt that should go towards funding the railways and on the relationship between funding from government and revenue from customers (i.e.: it is government that decides on the right balance between the interests of currents customers and funders and future customers and funders). We therefore find it difficult to understand the value of the scenarios set out in the consultation document in the context of the current market structure.

[8] See, for example, Appendix B in http://www.catrin-eu.org/index.php?option=com_docman&task=doc_view&gid=60

9. The incentive properties of opex and capex cost recovery (chapter 9)

9.1. We agree that this is an issue for private sector monopoly utility providers where the split between opex and capex can be critical in determining the cost of capital and the revenue requirement. However, we would tend to agree that in the context of the current ownership model this is unlikely to play a significant role in Network Rail's decision making.

10. Other incentives (chapter 10)

10.1. ***pteg*** recognises the need for NR and the wider rail industry to be funded for research and development and innovation. For example, PTEs are very keen to explore the potential for tram-train technology to deliver efficiency savings and passenger benefits in urban areas, and we believe that NR should be incentivised to take forward projects such as this. However we do not have a view as to whether a specific innovation fund is the best mechanism for delivering this. What is clear is that NR needs some form of R&D budget which is administered in an open and transparent way which meets the requirements of industry funders.

10.2. ***pteg*** supports the approach outlined with regards environmental incentives.