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Train Operators, Freight Operators, Department for
Transport, Transport Scotland, Network Rail, ATOC and
RFOA

Dear colleague

Efficiency benefit sharing mechanism

I am writing to provide you with an update to the letter that I sent to Network Rail, ATOC and the Rail Freight Operators Association on 11 November 2011 on the efficiency benefit sharing mechanism (EBSM).¹

EBSM for 2010-11

Our assessment of Network Rail's efficiency and financial performance for 2010-11² highlighted that there are a number of concerns with Network Rail's reporting of efficiencies. These concerns are:

- (i) Arup qualified its review opinion due to concerns about the robustness of Network Rail's processes for identifying and calculating renewals efficiencies;
- (ii) Arup identified that signalling renewals volumes may have been incorrectly recorded;
- (iii) there was a lack of supporting evidence for reported efficiencies relating to renewals categories which are not supported by agreed volume measures; and
- (iv) Network Rail recognised renewals savings for civils renewals despite the civils asset management policy having not been fully accepted by us;³

¹ Available at http://www.rail-reg.gov.uk/upload/pdf/efficiency_benefit_sharing_mechanism_111111.pdf

² Our annual efficiency and finance assessment of Network Rail for 2010-11 is at http://www.rail-reg.gov.uk/upload/pdf/nr_annual_assessment_2010-11.pdf.



We place a great deal of weight on the EBSM mechanism to align industry incentives. It is therefore important that any EBSM payments are based on robust assessments of efficiency achieved. If Network Rail's declared renewals efficiencies had been included in the EBSM in full then Network Rail would have outperformed in 2010-11 and approximately £40m would be payable to train operators.⁴ However, given the uncertainties could eliminate Network Rail's reported renewals efficiencies, we did not consider that it was appropriate to sanction any EBSM payments until we had sufficient confidence in the efficiencies that Network Rail reports. Network Rail recognised that it had not met our expectations and agreed to improve its processes for reporting efficiency in 2011-12.

We commissioned Arup to perform an interim review of Network Rail's Period 6 (mid-year) efficiency reporting. Based on these interim findings Arup concluded in January 2012 that Network Rail appears to have made substantial improvements to the quality of its efficiency reporting in 2011-12 to date.

Whilst we recognise the improvements that Network Rail has made to its efficiency reporting, there remain a number of areas of concern. The first is the accuracy of Network Rail's recording of renewals activity for which Arup will shortly undertake a follow-up assessment. We will incorporate Arup's findings in our annual assessment of efficiency. Second, whilst Network Rail has made some progress on developing a clear schedule showing the volume of civils work that it needs to do, there is still further work to do. We will consider whether Network Rail has made sufficient progress for us to reassess adjusting for reported civils efficiencies as part of our annual assessment.

In addition to this, we recently found Network Rail is contravening its network licence in respect of declining performance in the freight sector. It is also likely to contravene its network licence in respect of deteriorating performance of long distance passenger services.⁵ This is an important matter and we have requested that Network Rail reflects its

³ Specifically, Network Rail's civils asset management policy does not include detailed information about the volumes of renewals work required. Without this information it is not possible to assess whether Network Rail is delivering the necessary volumes of work, which is important for assessing any efficiency improvements.

⁴ Though payments to the majority of franchised operators would be clawed back by the Department for Transport and Transport Scotland under the "clause 18.1"/schedule 9 (no net loss, no net gain) provisions of the franchise agreements. No EBSM payments were made in 2009-10 as Network Rail had not outperformed the PR08 determination per the EBSM calculation.

⁵ See <http://www.rail-reg.gov.uk/server/show/ConWebDoc.10748> for further details.



failure to deliver these outputs in its reporting of efficiency. However, it is not yet clear how significantly Network Rail's failure to deliver outputs will affect its reporting of efficiency savings in CP4 to date.

We have therefore decided that our decision regarding 2010-11 EBSM payments will be made as part of our annual efficiency and finance assessment of Network Rail. Our aim is to publish our decision on the EBSM calculations for 2010-11 and 2011-12 in July, after Network Rail publishes its regulatory accounts.

Review of EBSM methodology

In our PR08 determination we said that after two years we would review the effectiveness of the EBSM mechanism and whether there is merit in altering its scope or detailed design, for example by aligning the EBSM to Financial Value Added (FVA) a measure which Network Rail has proposed for use in determining executive directors' bonuses. FVA is a measure of financial performance compared to its initial delivery plan for CP4. Following several meetings and correspondence with Network Rail to better understand how FVA will be calculated, we consider that FVA does not currently offer a better measure of efficiency than the current EBSM approach. In particular, FVA is primarily a measure of performance for a control period as a whole and was therefore not designed to assess efficiency or deferral of expenditure within a control period. We have also agreed that for calculating FVA purposes, Network Rail can make an assessment of modifiers such as operational and safety performance at the end of the control period rather than in each year within the control period. We therefore intend to maintain the current approach for calculating EBSM for 2011-12.

I am a copy of this letter on our website.

Yours sincerely

A handwritten signature in blue ink that reads 'Paul McMahon'.

Paul McMahon