

Paul McMahon
Deputy Director, Railway Markets & Economics
Telephone 020 7282 2095
Email paul.mcmahon@orr.gsi.gov.uk



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Charles Robarts, Network Rail
Alec McTavish, Association of Train Operating Companies
Lindsay Durham, Rail Freight Operators Association

Dear Charles, Alec and Lindsay

Efficiency benefit sharing mechanism

I am writing to provide you with an update on the efficiency benefit sharing mechanism (EBSM).

Background

As you are aware, we established the EBSM in our 2008 periodic review (PR08) in order to provide stronger incentives on train operators to support Network Rail's efforts to improve its efficiency. Under the mechanism train operators share 25% of Network Rail's outperformance of our PR08 determination for a number of elements of expenditure and revenue. If applicable, each operator will receive a payment in proportion to their variable track access charges. Separate calculations are made of EBSM each year, for England & Wales and Scotland. Sharing any outperformance is subject to train operators demonstrating that they have engaged with Network Rail to help drive the company's efficiency improvements. This is intended to ensure commitment and minimise the risk of free-riding.

We consider that providing such a financial incentive for train operators is in the interests of Network Rail, train operators and the longer term interests of the industry's customers and funders – as the effort and insights from train operators should help to reduce Network Rail's costs faster than would otherwise be the case.

The EBSM is not 'switched on' for franchised train operating companies, meaning that franchised train operators will not financially benefit through this mechanism in CP4 and any outperformance payments will flow through to DfT or Transport Scotland. We understand that franchises entered into since the time of our PR08 determination are covered by the mechanism. Open access passenger and freight operators are covered by the mechanism. We have had constructive discussions with government about the implementation of a version of EBSM at the route level in CP5, which we are taking forward through the 2013 periodic review.





Application of EBSM for 2009-10

No EBSM payments were made for 2009-10. Although Network Rail had made qualifying outperformance in respect of Scotland we did not deem it appropriate to sanction a payout given the uncertainty on the company's renewals efficiencies at the time.¹

EBSM for 2010-11

We recently completed our assessment of Network Rail's efficiency and financial performance for 2010-11.² Our assessment highlights that there are a number of concerns with the company's reporting of renewals efficiencies. These uncertainties mean that total outperformance for payout to train operators under the EBSM could lie between zero and about £40 million.³ Given the uncertainties we do not consider that it is appropriate to sanction any EBSM payments until we have sufficient confidence in the efficiencies that Network Rail is declaring.

Despite being unable to approve payments under the EBSM we remain committed to the mechanism and are disappointed that train operators are currently not able to realise the benefits of the mechanism and the effort they have made to engage and work with Network Rail to help deliver efficiencies.

We are currently discussing with Network Rail and the independent reporter, Arup, whether and how we can reach a more conclusive position on Network Rail's efficiency improvement in 2010-11. We are aiming to do this by the end of January 2012 so that, if applicable, we can approve payments before the end of the current financial year.

¹ Our analysis of EBSM is in our annual efficiency and finance assessment of Network Rail for 2009-10. This is at http://www.rail-reg.gov.uk/upload/pdf/nr_efficiency_assessment_0910.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.

³ 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.



Review of EBSM

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.

Since we established the EBSM Network Rail has made changes to the way it reports efficiency and outperformance. In particular, the company has introduced the concept of FVA (Financial Value Added) as a measure of its performance against our PR08 determination and will use this as part of its Management Incentive Plan. We consider that it is appropriate to consider aligning the calculation of EBSM with FVA (recognising that the EBSM calculation of efficiency outperformance is a subset of what is contained in FVA which covers all sources of outperformance). We plan to consult on this by the end of 2011-12, with the intention that any changes to the EBSM can take effect in respect of calculating EBSM for 2011-12.

I am copying this letter to Paul Collins and Robin Groth at DfT and Steven McMahon at Transport Scotland and placing a copy on our website.

Yours sincerely

A handwritten signature in blue ink that reads 'Paul McMahon'. The signature is written in a cursive style with a large initial 'P'.

Paul McMahon