Executive directors’ remuneration and the Management Incentive Plan

1. Thank you for our discussion on 12 July, and for your letter of 13 July. I am writing to give you our views on your proposals for performance-related retention payments (PRRP) and your plans to put in place new Annual and Long Term Incentive Plans. I set out our views on each in turn.

2. Overall, I want to make clear that we are in agreement with you about the importance of Network Rail’s recruitment and retention of the high calibre individuals it needs in order to meet the substantial challenges the company faces.

PRRP

3. Whether retention payments are required, and at what level, is a judgement that must be made by Network Rail. ORR must take a view on whether those payments, as part of an overall remuneration package, are compliant with Network Rail’s licence conditions, and in particular condition 16, which sets out the company’s obligations in relation to a Management Incentive Plan covering the remuneration of its executive directors. In taking this view, we have regard to the three objectives we set out in March 2011, ie: long term sustainable delivery, outperformance, and accountability and transparency. Although we must take a view on Network Rail’s Management Incentive Plan as a whole, we are satisfied that we can comment separately on the question of the PRRPs. This is because
these payments, whilst linked to incentives are primarily concerned with retention of key staff.

4. We discussed last year Network Rail’s proposal for retention payments and, having regard to our three objectives, expressed our view that any retention payments should be linked to performance. We are pleased that Network Rail has now linked the retention payments to the performance (as judged through the appraisal process) of the individuals concerned. Subject to the final and complete retention proposal continuing to meet our objectives, we are satisfied that your proposals on PRRP are compliant with Network Rail’s licence. I am also pleased to note that you regard the use of retention payments as exceptional, and that you are taking steps to address wider succession planning issues in the company.

**AIP and LTIP**

5. You are making good progress towards an AIP and LTIP that meet our objectives and are compliant with your licence, and I very much welcome the open and consultative approach you are taking as you develop them.

6. The AIP and the LTIP are closely linked in terms of the overall incentives on the executive directors to drive delivery and outperformance. We will therefore not be in a position to assess the extent to which either the AIP by itself, or the LTIP by itself, meets our objectives and complies with your licence: we will need to consider the package as a whole. However, we can provide some general comments on the AIP proposals that you have shared with us.

7. There are a number of developments from the previous AIP that we welcome, having regard to our objectives. These include a more metric-based approach, greater transparency and the fact that performance to target will generate target (rather than maximum) bonuses.

8. In our view, the extensive discretion that may be exercised by the RemCo in deciding awards should help to avoid perverse outcomes. But, as we discussed, it would be helpful to have greater clarity on how the RemCo proposes to exercise this discretion. For example, it would be helpful to be clear that, in the event of a catastrophic accident for which Network Rail was culpable, no bonuses would be paid. We have also asked you to think about how the RemCo might exercise its discretion in the event of Network Rail’s
failure to deliver meet regulatory targets or in the event that it was found to be in breach of its licence. This is particularly relevant at the moment, given the company’s position in relation to the performance targets.

9. In addition, we have asked you in to consider the weighting applied to freight performance and the pros and cons of possible different measures of efficiency, including REEM. As you know you will need to set out how the AIP will interact with the forthcoming LTIP. There are specific linkages between the two, most obviously as the AIP now includes cost efficiency, which will be included in the LTIP. We understand that you are approaching the development of these two aspects of the overall package sequentially, but our interest must be in the effects of the overall package on incentives with regard to our objectives and its compliance with your licence conditions. So the sooner you can share with us your thinking on the package as a whole the better. Linked to this, it obviously remains critically important for you to make a compelling value for money case for the package as a whole.

10. I look forward to hearing from you further on these points, and to hearing the outcome of the discussions at your forthcoming AGM.

11. I am copying this letter to your members, the Secretary of State for Transport, Steve Gooding and Nick Bisson at DfT, and to the Scottish Minister for Housing and Transport, and David Middleton at Transport Scotland. I am also publishing it on our website.

Yours sincerely

RICHARD PRICE
Chief Executive