ORR's Holding Network Rail to Account policy - impact assessment on approach for levying financial penalties and financial sanctions

Date 5 April 2019

This impact assessment should be read in conjunction with our [Holding Network Rail to account policy].

Policy	**…**
Policy area	ORR's approach to imposing financial penalties on Network Rail in CP6
Background	The purpose of this impact assessment is to assess the impact of the introduction of a new approach to financial penalties and financial sanctions in our regulatory toolkit. Our new policy includes two new approaches to the imposition of financial penalties which mean that the ORR could: • scale penalties to be capable of being funded by management bonuses (avoiding the diversion of funding available for operation, maintenance and renewal of the railway); and • impose financial sanctions (at the route/System Operator (SO) level) that will reduce the value of the financial performance measure (FPM) that Network Rail uses in its performance-related pay schemes . This has the potential to negatively affect bonuses for all Network Rail staff on a particular route or the SO. Careful consideration of financial penalties is required in light of Network Rail's reclassification as a public sector body. Reclassification means that Network Rail no longer has private capital at risk which reduces the likely effectiveness of financial penalties on the company.

[1] Network Rail currently uses the FPM as an important component in calculating performance-related pay (i.e. employee and management bonuses).

	Financial penalties remove funding from Network Rail and the operational railway (with fines ultimately paid to HM Treasury). Given that 70% of Network Rail's funding comes from network grants from the Department for Transport and Transport Scotland and taking into account all our Section 4 duties[2] it is important to consider alternative options to large scale financial penalties. Financial penalties must legally remain part of our toolkit. If ORR finds Network Rail in breach of its licence, we can take formal enforcement action, formal enforcement action could lead to the imposition of a financial penalty. Section 57A of the Railways Act 1993 provides ORR with the powers to impose a penalty of up to 10% of turnover. Where a financial penalty is required, we want to focus on making a positive difference for rail users. While the ORR will continue to have the statutory powers to impose a penalty of up to 10% of turnover, we consider that the two new policy approaches to financial penalties better support: • the principle that where we take enforcement action, we will clearly identify the parts of Network Rail responsible to provide stronger incentives on those teams; and • Network Rail's public sector status (reducing the need to resort to large scale financial penalties that remove vital funding for operations, maintenance and renewal of Network Rail's infrastructure).
Objectives	Our objective is to create a credible and legally compliant[3] policy on financial penalties which supports effective incentives for improved railway performance.

[2] These include ORR's duties to act in a manner which we consider will not result in Network Rail having difficulty financing its activities and the duty to have regard to the funds available to the Secretary of State

[3] 'Legally compliant' means that the policy satisfies the requirements of Section 57A of the Railways Act 1993.

Issues under consideration

The three options assessed in this impact assessment, include:

- **Option 1 'maintain the status quo'** of ORR imposing financial penalties of up to 10% of turnover (under ORR's CP5 penalties statement);
- **Option 2 'Scale financial penalties to be funded from management bonuses'**. While it is for Network Rail to decide how to fund any penalty, this would have the effect of enabling Network Rail to protect the funding available for the operation, maintenance and renewal of the network; and
- **Option 3 'Introduce financial sanctions'** which have the effect of lowering the value of the FPM scorecard metric for the relevant route/SO (with potential knock on consequences for both management and staff bonuses).

The table below compares the major impacts for each of the above three options.

	1) Maintain the status quo (no change to approach to financial penalties)	2) Scale financial penalties to be funded from management bonuses	3)Introduce financial sanctions (which lower the value of the FPM scorecard metric)
Impact on funding available for operations, maintenance and renewals (OMR)	Financial penalties would remove funding available for OMR. The amount of funding removed would depend on the scale of the penalty which is dependent on the nature of the licence breach and harm caused to rail users.	No funding from OMR would be removed if the penalty is paid directly from funding available for management bonuses (this is Network Rail's choice, but would be ORR's expectation). The effect of this is that critical OMR funding for the railway remains available.	No funding from OMR would be removed as the effect of a financial sanction is to reduce bonus pay for Network Rail staff. The effect of this is that critical OMR funding for the railway remains available.
Financial impact for Her Majesty's Treasury (HMT)	Financial penalty paid to HMT. The amount would depend on the scale of the penalty which is dependent on the nature of the licence breach.	Financial penalty from management bonuses paid to HMT.	No payment to HMT.
Financial impact for Network Rail	Assumption is that financial penalty will be paid from OMR. The scale of the penalty may also impact the FPM scorecard metric which can	Direct impact as financial penalty would be scaled to be payable from management bonuses and it would be the ORR's expectation that Network Rail	Reducing the FPM can reduce management bonus pay for all staff in the affected routes/SO, including Network Rail senior management. The exact impact would depend on the scheme rules put in place by

senior management	reduce bonus pay for all Network Rail staff. The impact of this would be dependent on the size of the financial penalty imposed and the health of the FPM metric on a route/SO.	would pay the penalty from management bonus pay.	Network Rail, but is likely to be much more significant for senior management than for other staff.
Financial impact for Network Rail other staff	The scale of the penalty would impact the FPM scorecard metric which can reduce bonus pay for all Network Rail staff. The scale of the impact would be dependent on the size of the financial penalty imposed and the health of the FPM metric on a route/SO.	None - financial penalties would only affect Network Rail relevant senior management pay (assuming Network Rail chooses to fund penalty this way).	Reducing the FPM can reduce management bonus pay for all staff: the potential to provide a direct financial incentive for all staff within the wider bonus scheme. The exact impact would depend on the scheme rules put in place by Network Rail. Financial bonuses are proportionately smaller for junior staff, therefore the scale of effect is lessened moving down the management chain.
Reputational impact on relevant management teams	When imposing a financial penalty, the ORR would publish a penalty notice outlining the size of the penalty and why it has been imposed. The reputational impact here is largely on Network Rail as a company and to some extent the route/SO, rather than particular individuals having responsibility. This can have a reputational impact at the company level, but is likely to have a lesser impact on the reputation of specific management teams.	The ORR will clearly signal in the published penalty notice that not only has Network Rail failed to comply with its licence obligations but that the ORR believes that Network Rail senior management/its Executive and/or Board were culpable. This will provide a strong reputational incentive for Network Rail senior management/Executive and/or Board to avoid such penalties.	When imposing a financial sanction, the ORR will clearly signal in the published penalty notice the responsible routes/SO affected. This is likely to have a reputational impact on the relevant senior management teams.
Behavioural impact	Financial penalties paid from OMR are less likely to change behaviour as the impact of this penalty removes funding from the business rather than directly from management pay. Depending on the scale of the penalty it may also impact the FPM scorecard metrics which could reduce bonus pay to some extent for all Network Rail staff. The impact of this would be dependent on the size of the financial penalty imposed and	The main potential behavioural effects are likely to be through three channels: • Staff (senior management) anticipating that bonuses are at risk if ORR takes enforcement action – presenting both a financial and reputational harm risk – so they should be strongly motivated to try and avoid a licence breach.	Given the potential direct impact on bonus pay for all eligible staff, it is anticipated that this would drive positive behaviours from the staff within Network Rail route and/or the SO. The main potential behavioural effects are through the same channels as for Option 2, but would apply to all staff, not only senior management. Less senior staff will be likely to have less control over the occurrence of a licence

	the health of the FPM metric on a route/SO.	• In the event that any bonuses were significantly reduced before the end of a financial year, senior management could have dampened incentives to perform within that financial year: a risk that less effort is therefore given to achievement of targets. We would take this into account in any penalty decision. • Potential applicants to senior posts at Network Rail may consider the risk of losing bonuses when considering the overall remuneration package (although there is a risk of deterring good applicants, there may also be a self-selection effect where posts only attract applicants confident in their capability to perform the job effectively).	breach and therefore imposition of a sanction. However the direct impact on staff of a sanction is proportionate to seniority because of the smaller scale of bonuses for less senior staff. The behavioural impact would be commensurately smaller for less senior staff.	

Options to be considered
Option 1: Maintain the status quo (no change to approach to financial penalties) In this option we do not propose to change our approach to financial penalties. All other options have been assessed relative to this 'do nothing' option.

Option 2: Scale financial penalties to be funded from management bonuses

Advantages (relative to Option 1)

- This option better reflects the changed structure of Network Rail and its public sector status. Network Rail's reclassification as a public sector body means that it no longer has private capital at risk which reduces the likely effectiveness of financial penalties on the company. Choosing to scale any financial penalty to be capable of being funded from management bonuses (of the responsible business units or national functions) would mean that Network Rail would fund a penalty from bonus pay instead of removing funds available for operations, maintenance and renewal of the rail network (which is one of the main disadvantages of option 1). This will ensure that the funding available to Network Rail for delivery of its CP6 commitments is protected throughout the duration of the control period.
- Scaling financial penalties to be capable of being paid from management bonuses presents an opportunity to provide stronger reputational incentives than Option 1. Scaling financial penalties to be capable of being paid from management bonuses also provides a direct financial incentive for the responsible Network Rail senior management of a particular route or the SO.

Disadvantages (relative to Option 1):

- This option could present a risk to the recruitment of senior management/executive level positions as the threat of enforcement action could be perceived as a risk to potential future bonus payments. The severity of this risk is likely to depend on how ORR applies any penalties in practice.
- If a financial penalty also has the effect of nullifying bonuses through achievement of route scorecard metrics then there is a potential risk that less effort is given to achieving targets as there would be no financial reward for doing so.

Alignment with objective

- This option remains legally compliant while providing an alternative approach that supports effective incentives for improved railway performance and reflects Network Rail's public sector status.

Option 3: Introduce financial sanctions (which lower the value of the FPM scorecard metric)

Advantages (relative to Option 1)

- This option is similar to option 2 in that it also better reflects the changed structure of Network Rail and its public sector status. Choosing to impose a financial sanction would mean that funds available for operations, maintenance and renewal of the rail network are protected.
- The option presents an opportunity to provide stronger reputational incentives for all Network Rail staff than is the case under Option 1. Financial sanctions will have the potential to provide a direct financial incentive for all staff of a particular route or the SO.
- Any funding not used for bonus payments could be reinvested in operations, maintenance and renewal activities.

Disadvantages (relative to Option 1):

- The use of financial sanctions reducing bonuses could impact Network Rail's ability to motivate and retain its staff. This is likely to depend on how ORR applies the policy in practice.

Alignment with objective

- This option remains legally compliant while providing an alternative approach that supports effective incentives for improved railway performance and reflects Network Rail's public sector status.

Conclusion

Our conclusion is that both options 2 and 3 should be in the policy

We consider that these options best incentivise Network Rail to deliver for its customers and funders. It also best reflects the reclassification of Network Rail and changes made to Network Rail’s operating structure. They are both an improvement on option 1.

Having both options 2 and 3 introduces some flexibility to take the best approach depending on circumstances (for example, to the extent there are significant changes to Network Rail’s performance bonus schemes, this could particularly affect option 3).

We fully recognise that there are some potential negative impacts of both scaling a financial penalty to be paid from management bonuses and financial sanctions. To address this the holding to account policy clearly sets out that when taking decisions about what action to take in response to a licence breach, the ORR Board would carefully consider all available options and the implications of each of those options.

Our policy will also clearly state that we consider that a financial penalty or financial sanction would always be a last resort. We would also consult with Network Rail before making a final decision.