

Periodic Review 2013

Consultation on Incentives

Centro Response

1. Background

- 1.1. Centro welcomes the opportunity to respond to this important consultation on incentives in CP5. The rail network is a critical asset supporting the West Midlands economy and both passenger and freight usage has grown strongly despite the recession. 27% of all commuter journeys into central Birmingham are now made by rail, up from 17% just 10 years ago. It is therefore essential that the rail network continues to deliver the connectivity and capacity requirements needed to support sustainable economic growth in the region.
- 1.2. Centro has voiced strong concerns that the proposed investment programme outlined in the Initial Industry Plan will not meet the future economic requirements of the West Midlands. Our concerns were outlined in our response to the IIP which was submitted last October. However we support many of the proposals outlined in the IIP, and particularly recognise the need for the industry to cut costs. This is even more relevant for the West Midlands where services are heavily dependent on taxpayers subsidising rail services, and where the current high industry costs make it difficult to generate the business cases needed to justify investment.

2. Devolution

- 2.1. Centro welcomes the recognition that localism and devolution could have a major impact on the PR13 outcomes. Centro is actively investigating how devolved decision making on rail could be implemented in the West Midlands. We believe that from September 2015 when the current London Midland franchise expires, that there should be locally specified franchise managed by Centro covering the wider Birmingham Travel to Work area. The definition of this franchise is still under consideration; however we expect to be responding to the forthcoming DfT consultation on devolution with an outline proposition in due course.
- 2.2. Centro's approach to the specification of a new franchise is, however, likely to involve:
 - Centro taking revenue risk, setting fares, promoting rail services
 - Centro taking on more responsibilities with respect to stations

- Centro defining detailed outputs for the operator to deliver, recognising the degree of public subsidy needed to support the services
 - Centro taking a flexible approach to changing service levels and outputs as required over the life of the franchise to optimise outcomes and value for money
- 2.3. This approach will require that the PR13 process creates the opportunity for Centro to effectively deliver an effective locally specified franchise. In particular, issues such as Centro taking revenue risk mean that some industry relationships will need to be redefined, as Centro would have a much more direct financial interest in ensuring that Network Rail delivers a reliable rail network, and we would also have a need to understand Network Rail's costs and outputs on a more disaggregated level.
- 2.4. The CP5 outputs and PR13 conclusions are therefore of great importance to us and we would hope that the ORR will consider the implications on devolved franchises as decisions on the incentives framework are taken.

3. Understanding the PR13 Objective

- 3.1. Centro agrees that in PR13 the ORR should focus on incentivising the outcomes that customers, wider society and funders value.
- 3.2. The definition of customers in this instance needs to be carefully defined, as the objectives and outcomes desired by Networks Rail's direct customers (i.e. TOCs and FOCs) may not always be directly aligned with the outcomes desired by passengers and freight users. This is particularly an issue in the highly subsidised PTE franchises where there is little commercial incentive on a TOC to grow its customer base, and indeed a TOC could view that attracting additional peak passengers will only add to its costs without a corresponding increase in revenue.
- 3.3. The wider societal benefits of rail are therefore of key importance in PTE areas where farebox revenue does not fully capture the wider economic benefits flowing from growing rail usage or improving connectivity. It is therefore essential that Network Rail is incentivised to recognise these wider benefits when considering its processes for improving the network or allocating capacity.
- 3.4. Centro is very keen to work with Network Rail to understand in more detail the wider economic and societal benefits that rail delivers in the West Midlands, and to ensure that these are embedded within its decision making processes.
- 3.5. Centro recognises, however, that there will always be a need to make trade-offs between the amount that taxpayers and passengers contribute to the costs of running the network and services. However, if the costs of

rail service provision can be significantly reduced then making these trade-offs is far easier and requires less compromise.

- 3.6. The passenger outcomes desired by urban commuters in PTE areas is largely aligned national priorities, although clearly the needs of local passengers are very different to long-distance users. In particular service frequency is very important for the short-distance journeys undertaken in the West Midlands, and peak capacity is also an important factor.
- 3.7. Journey time is less important for the inner-urban journeys, where rail is already very competitive with the congested road network. However improving journey time for some of the longer-distance commuter flows (e.g. from Kidderminster or Northampton into Birmingham) has some potentially very important wider economic benefits for the region. Centro has commissioned KPMG to undertake economic analysis of some of the GVA and jobs benefits which could accrue from delivering rail service improvements. This shows that the maximum benefits tend to be delivered when journey times in the 45 minute to 1 hour band can be reduced as this significantly increases the potential labour markets for the key economic centres.
- 3.8. The trade-off between punctuality and other factors (e.g. frequency, fares, etc) is also a very important consideration. Passengers expect that trains should operate to the advertised timetable on 90-95% of occasions, but recognise that 100% reliability is never going to be possible. When delays are unavoidable, mitigating the impacts with excellent information and customer care is essential.
- 3.9. Centro believes that the current balance between performance and service provision in the congested West Midlands network is probably about right, and we certainly would not consider that reducing train frequency to improve performance is appropriate.
- 3.10. Connectivity is also a key issue for the West Midlands, where there is generally poor connectivity across Birmingham for many flows (e.g. Coventry to Walsall, Worcester to Birmingham International), requiring passengers to make highly unattractive changes to make journeys. Options to improve connectivity should therefore deliver substantial passenger and economic benefits.
- 3.11. Centro believes that outcomes and outputs specified for NR to deliver have to be measured at a local West Midlands level (and not just at NR Route Level). Outputs, however have to be carefully defined to avoid NR narrowly focusing on a specific target to the exclusion of wider objectives. For example, a specific target on improving journey times on key commuter flows into Birmingham could well have detrimental effects on service frequency or performance. Such targets would also have to be considered in the context of the franchise structure, where the West Coast franchise will be operating to a less defined and more flexible Train Service Commitment than a future West Midlands franchise.

3.12. Centro notes that the balance of funding which comes from Access Charges and that which comes from direct government grant could influence Network Rail's behaviour. For heavily subsidised PTE franchises where there is a significant taxpayer input, it is important that Network Rail recognises this in its behaviour and doesn't just focus on the more commercial operators. Centro recognises, however, that how a future WM franchise is specified will be critical in this regard and the degree of subsidy flowing to NR through the franchise or directly from funders (from either DfT or via Centro) will have implications on this arrangement.

3.13. Under any devolved arrangement, Centro would become a very significant customer of Network Rail, representing the interests of both passengers and taxpayers. However Centro is also likely to have a strong role in representing interests of the wider West Midlands economy although it is recognised that at present policy on the role of LEPs, elected mayors and transport governance is still emerging.

4. Aligning Network Rail and train operators' incentives to increase efficiency

4.1. Centro recognises the deficiencies in the current mechanisms available to incentivise operators and Network Rail to work together to increase efficiency and reduce costs. Centro considers that this works both ways in that TOCs do not generally benefit directly from any changes in access charges due to Franchise Agreement provisions, and similarly Network Rail does not benefit directly from investments which improve a TOCs operational efficiency - e.g. introducing a turnback facility which reduces rolling stock requirements.

4.2. However, Centro is concerned that the opportunities to make significant cost savings beyond that which the current structure is delivering may be limited in the West Midlands, as there are a number of barriers which hinder the delivery true partnership working on a mixed use network. Where there is a dominant operator and alliancing type arrangements are possible, then there is likely to be more opportunities for the TOC and NR to work together to reduce costs.

4.3. It should also be recognised that some cost saving opportunities have already been delivered with current structures, such as the innovative Parry People Mover on the Stourbridge Town branch.

4.4. Many costs in the industry arise from the application of standards and processes which often make it so time consuming and difficult to challenge areas of perceived over-specification, that it is often easier to live with a cost impact than risk a scheme delivery programme. A significant element of scheme costs are often Schedule 4 possessions charges which TOCs should be encouraged to waive where the benefits of a scheme accrue to them.

- 4.5. It is also unclear the extent to which TOCs would be willing to put significant resources into reviewing NR's working practices and challenging staffing levels. It is also unclear the extent to which NR would be willing to accept this level of scrutiny.
- 4.6. It is a concern that unless some of the systemic cost drivers are tackled then a TOC's only opportunity to drive lower cost levels might be to challenge the deliverables – e.g. do we need specific items of infrastructure, do we need this line speed, etc? While there are certainly areas where these need to be challenged, we need to be wary about incentivising a process which encourages reducing network capability. On mixed used networks, there is also the issue that other operators can effectively veto proposals which they view as worsening their business.
- 4.7. The proposed route-level efficiency sharing mechanism appears a very cumbersome mechanism for incentivising outperformance against targets. For example across the whole of LNW route it is highly unlikely that all the operators would wish to engage on how NR manages its business across the area – e.g. Chiltern Railways is unlikely to challenge NR on cost savings on the Cumbrian Coast Line. However, Centro does believe that there could be value in promoting joint schemes under bespoke arrangements, and guidance should be drafted to facilitate this. So that, if for example, Northern Rail and NR develop an innovative scheme to reduce the operational and maintenance costs of the Cumbrian Coast line, then both parties would benefit.
- 4.8. Similarly, if there is a new West Midlands franchise specified by Centro, then Centro would expect to be able to share in any financial benefits flowing from making changes to the franchise specification which results in cost savings. Centro would clearly need to ensure that any franchise terms are appropriately drafted to facilitate this.
- 4.9. Centro would welcome further consideration on whether a process for operators being exposed to NR costs at a periodic review could work. However, Centro would need to understand how such an arrangement might work in the context of a Centro-funded WM franchise and would need a full understanding of how future government funding for PTE franchises might work.

5. Possessions and Performance Regimes

- 5.1. Centro understands the rationale behind the Schedule 4 and 8 regimes, and would really like to understand further the extent to which the payments truly reflect the revenue impact of good or bad performance. At present Centro has no visibility as to the payments taking place between the TOCs and Network Rail, and would certainly like to understand more about the local West Midlands payments being made to/from London Midland before being able to pass full comment.
- 5.2. However, the payment rates for these regimes drive a lot of industry costs (e.g. capacity charge levels) and Centro believes that they should

be set at the lowest possible rate to incentivise good performance. Hence better understanding the link between the regimes and behaviour (both at TOCs and NR) is crucial. Also, understanding the linkage between PPM based performance incentives (such as typically exist with Franchise Agreements), and Schedule 8 is important.

- 5.3. In PTE areas, the revenue impacts of delays could be quite low given the short journey lengths and fare levels, yet the societal impact of a delayed commuter service with 500 passengers on is likely to be high. It is not clear the extent to which NR's behaviour might be swayed towards focusing management effort on high-earning long-distance services at the expense of local services as a result of this.
- 5.4. With Centro potentially taking revenue risk in a new WM franchise, we would have a direct interest in ensuring that any compensation flowing from the regimes is passed on to us. However, Centro agrees that the payment level should not necessarily reflect the full revenue impact of delays as long as there are other protections in place which allow for compensation to flow as the result of high-impact events that have major disruptive effects, and there are other processes in place to encourage good performance (e.g. publication of line-by-line performance information).
- 5.5. Centro supports the negotiation of bespoke arrangements where appropriate as long as there are adequate protections in place to protect the interests of all users of the network (e.g. to ensure that WC Franchise services don't receive preferential regulation over LM services as a result!).

6. Access Charges

- 6.1. Centro supports the general principle that access charges should broadly reflect Network Rail's costs, and therefore the charging regime should be sufficiently flexible to recognise variations across routes. Centro therefore supports the principle of disaggregation, where there is sufficient cost information to support local variations in charge.
- 6.2. Centro has previously expressed its concerns over the Capacity Charge which we do not consider to be currently reflective of Network Rail's costs and has directly led to Centro-supported services in the West Midlands being withdrawn due to them being unaffordable.
- 6.3. Centro does not have sufficient visibility of Network Rail's true costs arising from Schedule 8 to know whether the charge levels are in any way reasonable, however it seems to Centro extremely unlikely that Network Rail is incurring the costs implied by the Capacity Charge in all instances. For NR to be earning more in Capacity Charge than it does in Variable Track Access charge implies that an essentially artificial performance regime is generating higher industry costs than the actual marginal maintenance and operational costs associated with physically running the trains.

- 6.4. Given that the capacity charge is in effect a charge that TOCs pay Network Rail for NR to then subsequently pay back to TOCs in Schedule 8 payments, it is (in theory) an entirely circular money-go-round which add little value to the industry, but does unnecessarily raise costs. Centro therefore believes that the charge needs to be fundamentally reassessed.
- 6.5. Centro believes that at the start of CP5 the Schedule 8 regime is recalibrated to reflect the level of train service running on the network, and in effect this acts as the benchmark for the level of congestion related delay on the network. The recalibration should effectively negate the capacity-charge money-go-round which currently occurs, and all services running at the beginning of the control period should not have to pay it. In effect the TOCs don't pay NR £158M per annum (2010-11 payment) in capacity charge, and NR doesn't then pay this back to them in Schedule 8 payments as a result of Schedule 8 benchmarks being adjusted (recognising that there will be winners and losers as the charge is redistributed between TOCs, although most will be protected through their franchise agreement provisions). TOCs will therefore receive less Schedule 8 compensation from NR, but won't have to pay out in capacity charge for the services running at the start of the control period.
- 6.6. If new services are subsequently added which can demonstrably show an additional Schedule 8 performance impact on NR then this should be reflected in the charge. Conversely, if a train service is removed which has a performance benefit to NR, then the TOC should receive a rebate payment to reflect this.
- 6.7. Centro is currently engaged in negotiations relating to seeking capacity charge relief on the Coventry – Nuneaton line where Centro investment will deliver performance benefits. Centro is keen that this principle is recognised in general, and bespoke arrangements such as this can be implemented where appropriate.

7. Capacity Utilisation Incentives

- 7.1. Centro remains unconvinced of the value of trying to use charging mechanisms to significantly influence the allocation of capacity on a congested network.
- 7.2. While economic theory may indicate that the use of capacity could be optimised through a charging mechanism, Centro believes that there are so many factors preventing the operation of a free market in the planning and delivery of rail services, that all that a charging mechanism would do is to unnecessarily increase the cost of providing rail services.
- 7.3. Centro finds it hard to believe that there is significant available capacity on the congested West Midlands rail network which could be freed up by a charging mechanism. There has been considerable work done by the rail industry through the RUS process to review current network usage and this allowed the consideration of the allocation of network capacity

to be undertaken in a holistic way, recognising the intrinsic value of various rail services. The RUS process challenged where appropriate stopping patterns, frequencies and other aspects of the service pattern to determine the appropriate usage of the network. While this process was not undertaken on a “blank sheet of paper” basis, it did consider opportunities for changing services or adding new services.

- 7.4. Network Rail also has to adhere to a clear timetable planning process with a complementary process for granting new access rights. These also act to encourage Network Rail and TOCs to cooperate to develop optimum timetable solutions.
- 7.5. Centro would be extremely concerned if these joint industry processes were supplemented by further market mechanisms. Centro in particular is concerned that in any market based assessment of capacity usage, it is likely to be the local urban passenger services which get squeezed due to their intrinsically low commercial value (but high social value). The only possible outcome of this is that the taxpayer would have to pay more to protect services which operate on congested parts of the network which have high social and economic value, but low commercial value. Given that it is highly unlikely that a PTE would receive any financial benefit from releasing a path for an urban service to a long-distance train, this would have the effect of pushing up the cost of providing local urban rail services still higher and go directly against the vfm agenda.
- 7.6. As discussed above Centro does not support the capacity charge in its current form, and similarly does not support the proposed scarcity charge.
- 7.7. Centro is not convinced that the Volume Incentive has driven any particular change in behaviour by Network Rail, and we are not clear how effective it is in its current form. Given that new rail services are driven either by TOCs or funders, Centro is not convinced that paying Network Rail further incentive payments will encourage greater use of the network. Centro would like to see evidence of how the charge has influenced NR and grown rail usage before taking a view on any future proposals. We would be particularly concerned if NR was able to benefit from a volume incentive where 3rd party investment in infrastructure has facilitated the increase in network usage (such on the proposed Coventry to Nuneaton line upgrade project) .

8. Network Rail’s Cost of Capital and Financing Arrangements

- 8.1. Centro recognises that there are some complex issues which need to be considered when looking at the appropriate financing mechanisms for NR in CP5, especially considering NR’s unusual corporate governance structure and its substantial reliance on taxpayers to support its activities. Centro believes that it will be crucial that this issue fully considered once the principal funders (DfT and Transport Scotland) have outlined their approach to funding when the SoFAs are published.

Centro suggests that the preferred approach to financing NR is also capable of supporting a more devolved funding process should greater levels of DfT funding be channelled through PTEs in future.

9. The Incentive Properties of Opex and Capex cost Recovery

9.1. Centro has no evidence that the treatment of different classes of expenditure has impacted on operating decisions on the ground. Centro has some concerns that there is a tendency to over-engineer in certain circumstances, but it is not clear whether this is driven from a desire to reduce long-term costs, or from the application of gold-plated standards. Centro believes that it is far more likely to be standards and other obligations which are driving capex levels rather than a long-term view of costs. However, Centro has certainly noticed a recent tendency on NR to de-scope some signalling renewals work to save capex. Unfortunately, some of this descoping has subsequently increased the cost of undertaking subsequent enhancements.

10. Other Incentives

10.1. Centro 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 Centro does not have a view as to whether a specific innovation fund is the best mechanism for delivering this, however it is clear 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. Centro supports the approach outlined with regards environmental incentives.

11. Conclusions

11.1. Centro believes that there various aspects of the incentives framework which needs to be subject to critical review to really understand whether a different approach can lead to a reduction of industry costs. Aligned with this, Centro is actively investigating the potential for a devolved franchise in the West Midlands, and this will also need an effective incentive and charging framework if it is to deliver efficiencies. A better understanding of Network Rail's costs at a local level, coupled with a appropriate charging mechanism will be key to delivering this.

11.2. Centro would welcome more evidence on the effectiveness of the performance regimes in driving appropriate behaviour before accepting that the huge money flows generated by the regimes are really necessary.

- 11.3. Centro is not convinced that the proposed efficiency benefit sharing mechanism will be effective in its proposed form, but welcomes further work on developing mechanisms which would allow TOCs, funders/specifiers and Network Rail to share in efficiency savings through collaborative working.
- 11.4. Centro remains concerned that any form of capacity utilisation incentive such as a scarcity charge would only act to further increase the already high costs of running urban rail services and would ultimately be to the detriment of providing the West Midlands with a high quality transport system to support sustainable economic growth.