Network Rail's response to ORR's consultation on changes to charges and contractual incentives

9th March 2017

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Executive Summary

Introduction

1. Network Rail is pleased to respond to ORR's December 2016 consultation on the charges and contractual incentives regime for CP6. We welcome ORR's open approach to discussing its emerging proposals with the industry, particularly in the lead-up to the publication of this consultation.
2. We support many of ORR's proposed refinements to the charging and incentives framework for CP6. We also welcome the fact that ORR plans to conclude on some aspects of the framework in June 2017, rather than waiting until its June 2018 Draft Determination.
3. Early certainty in relation of ORR's charging policy will help us to engage in more constructive discussions with train operators in relation to the track access charges that they are likely to face in CP6. Consistent with this, we are planning to consult with industry on the more detailed aspects of the charging and incentives framework for CP6 in summer 2017. However, ORR should be aware that until it reaches firm conclusions regarding its charging policy for CP6, we will not be able to start the detailed recalibration process or initiate the required work to update our billing systems, if that is necessary.
4. Whilst we support the vast majority of ORR's proposed refinements to the charging and incentives framework for CP6, we are concerned about what appears to be limited progress in relation to the development of policy options for the Capacity Charge and some aspects of Schedule 8. These areas were identified as a priority for reform as part of the RDG Review of Charges project. Schedule 8, in particular, can have a significant impact on Network Rail's and operators' business models.
5. Indeed, we are concerned that time is already tight to conclude the recalibration process for some aspects of the regime in time for the start of CP6, in particular for Schedule 8. It is important, therefore, that ORR provides additional clarity in this area as soon as reasonably possible.

Wider PR18 context

6. The PR18 work programme is ambitious, notably the work required to implement route-level and system operator regulation. We welcome the fact that ORR is prioritising work in these areas, and seeking to limit changes to the charging and incentives framework in CP6.
7. We consider it important that the charges and incentives framework in CP6 supports industry priorities and objectives, including Network Rail's commitments in its Transformation Plan. For example, a key priority will be the ability to attract third-party investment to the railway network, which will require a flexible charges and incentives framework that is capable of accommodating different ownership models.
8. We also note the plans outlined in the Secretary of State's December 2016 written statement to Parliament on rail reform: the future of the rail network, which discusses the need for incentive alignment between Network Rail and operators. It will be important that any changes to incentives are seen in this wider context and support this 'direction of travel'.
9. Safety continues to be of paramount importance for us. Therefore, consideration of the impact on safety of any proposed changes is critical. We welcome that ORR has

included improvements in safety in its general criteria for carrying out the impact assessments on its policy proposals (which we discuss later in this response).

Areas of support

10. We are mindful that some train operators' business models are vulnerable to changes in the Variable Usage Charge (VUC). Therefore, we strongly support ORR's proposals not to make fundamental changes to the structure of the VUC for CP6.
11. We also support ORR's proposals to narrow the scope for claims in respect of sustained poor performance (SPP) in Schedule 8. We welcome ORR's proposal to review the clarity of the contractual wording for SPP. We look forward to contributing to this review and suggest that there should be a time limit for claiming for SPP in CP6.
12. We agree that there should be improved transparency around who is 'responsible' for our fixed costs, and that the cost allocation work which Network Rail has commissioned should be used to inform this improved transparency.
13. We also welcome many of ORR's proposals for incremental improvements to Schedule 4, in particular the proposed review of the Notification Discount Factors (NDFs).
14. ORR is consulting on the inclusion of passenger compensation in the performance regime. We recognise the need for passengers to be appropriately compensated when they experience disruption on the railway. However, if passenger compensation is to be included in the Network Rail performance regime in CP6, we will need funding to recover this potentially significant additional cost. We would also be concerned if this changed the nature of the relationship between Network Rail, passenger operators and passengers. It might therefore be better for train operators to pay for all passenger compensation rather than introducing potential conflict through the allocation between Network Rail and operators.
15. We also support ORR's proposal to simplify the freight charging regime by removing and/or consolidating freight charges, where appropriate.

Areas of concern

16. As set out above, there are many aspects of ORR's proposals that we support. However, we also have significant concerns about the Capacity Charge and some aspects of proposed Schedule 8 reform. In particular, we are concerned that the consultation proposals for these aspects of the regime are not yet fully developed. This is creating uncertainty across the industry and could also impact our ability to undertake the detailed calculation activities that are required to recalibrate these regimes for the beginning of CP6.
17. We will continue to participate in industry discussions to further develop proposals for these areas of the regime. We will need further clarity from ORR on its proposals in these areas if we are to commence Schedule 8 recalibration activities in summer 2017.

<u>The Capacity Charge</u>

18. We consider that the two options for the Capacity Charge on which ORR is consulting may not be practical for CP6. In particular, we are concerned that the current consultation proposals do not address the purpose of the Capacity Charge (i.e. the need to compensate Network Rail for higher Schedule 8 costs when more trains are added to the network). If our higher Schedule 8 costs are not recovered in CP6, we will be

financially worse off when more trains are run on the network. This would be an unacceptable outcome as it would be a disincentive to support growth and inconsistent with ORR's confirmed aim for PR18, which includes a better used railway in CP6 and beyond.

19. It is critical that Capacity Charge policy development is prioritised over the coming weeks. We will continue to work closely with the industry and ORR on the development of a workable solution for CP6. For a more detailed discussion on our concerns, please refer to our response to Questions 8 and 9 of ORR's consultation.

Schedule 8

20. We are also concerned that ORR's proposals with regards to setting Schedule 8 benchmarks are not well developed for this stage in the periodic review. In order for the Schedule 8 recalibration work to be completed in time for CP6, work will need to start in summer 2017. The lack of policy proposals, specifically in relation to Schedule 8 benchmarks, could place considerable strain on the required recalibration activities and the ability, therefore, to implement the recalibrated regime for the start of CP6. We welcome ORR treating this as a priority at the recently established ORR industry Schedule 8 recalibration working groups.
21. It is also important that ORR is committed to making sure that all available evidence is used to inform the recalibration of Schedule 8 payment rates for CP6, where the evidence is robust.
22. The Passenger Demand Forecasting Council (PDFC) is extending a recently commissioned Network Rail study that suggested the Network Rail Schedule 8 payment rates for London commuter services appear to be significantly too high. This is of particular concern given the substantial money flows resulting from Schedule 8 to London commuter TOCs in CP5. If payment rates do not accurately reflect revenue elasticities, the regime will not have the desired aim of 'de-risking' franchises from the effect of performance levels being different from what they were assumed to be. We urge ORR to take this new information into account in setting Schedule 8 payment rates for CP6. In addition, Schedule 8 payment rates also inform Schedule 4 revenue compensation rates. We are concerned that if Schedule 8 rates are 'wrong', this could distort the costs of taking possessions on the network. Our response to ORR's questions on Schedule 8 provides a more detailed discussion on the level of Schedule 8 payment rates.
23. More generally, it is crucial that the Schedule 8 benchmarks for train performance are set at an attainable level. We will continue to work with the industry to set appropriate performance targets, through our route stakeholder engagement process. If the Schedule 8 benchmarks are not set at a realistic level Network Rail could be faced with very significant outflows of money through Schedule 8 payments, potentially reducing our ability to invest in the rail network in CP6.

Incentives to grow traffic

24. ORR's consultation notes a concern that we have previously raised about not facing appropriate incentives to grow traffic on the network. We continue to consider that the incentives that we face to grow traffic could be improved. We are pleased that ORR recognises this issue in its consultation.

25. Whilst we strive to accommodate our customers' requests to run more services, we do not consider that the income that we currently receive provides us with a strong financial incentive to do this.
26. We believe that some of the potential changes that ORR notes in its consultation could strengthen the financial incentives that we face to grow traffic. For example, ORR suggests levying fixed track access charges on franchised passenger operators on a per mile basis and refining the volume incentive. Both of these are interesting ideas which we would like to explore further with ORR and industry stakeholders. However, because these potential changes are discussed only at a high-level in the consultation document and supporting impact assessments, it is hard for us to form a firm view on the impact that these proposals would actually have.
27. We would welcome ORR setting out the potential changes that it is considering in this area in more detail. This would help us to form a view on whether, in reality, these changes would strengthen our incentives to grow traffic, and could be implemented in time for CP6.
28. We also consider it important that potential changes in this area are considered in the round. In particular, we suggest that ORR is mindful of the overall impact of any changes to the Capacity Charge, Volume Incentive, and Fixed Cost charges together. If changes are made to these parts of the framework in isolation, it could actually weaken our incentives to grow traffic, rather than strengthen them.
29. We are specifically concerned about suggestions that ORR may use the Volume Incentive to make up for any funding shortfall on Network Rail as a result of changes to the Capacity Charge. In its draft impact assessment on options for fixed costs, ORR also suggests that changes to the Volume Incentive may be required to adjust for any shortfall in revenue created by the application of the market can bear test for freight and open access operators. If the volume incentive operates in the same way as in CP5, any payment would not be received by Network Rail until CP7, so would not help in paying for cash costs incurred by Network Rail in CP6 - for example, higher Schedule 8 costs from running additional trains. Any cash shortfall would, potentially, need to be made up by cutting expenditure in other areas such as renewals.

Impact Assessments

30. We welcome ORR's development of draft impact assessments on how changes to the charges and incentives regime will impact stakeholders, as well as its commitment to considering the cumulative financial impact of changes on operators. (We note that it is planning to publish a working paper in early 2017 to outline its methodology for this work). As above, we also welcome that improvements in safety is considered in the general objectives and criteria which are used to inform the impact assessments.
31. We recognise the challenges associated with carrying out these sorts of impact assessments. We are concerned, however, that ORR's approach to the current draft impact assessments is, in some cases, inconsistent. For example, not all of the charging proposals have been assessed against ORR's general criteria. A consistent approach is helpful, particularly in order to be able to take a holistic view of all the proposals, as well as to understand the full impact.
32. We also note that in the case of the VUC, ORR did not publish an impact assessment. Even where ORR is proposing to broadly retain the existing charging structure, we

consider that it would be prudent to understand the impact of the proposal on the relevant stakeholders by conducting an impact assessment.

33. There are also instances, for example the fixed cost charges impact assessment, where ORR has considered policy changes that are not discussed in its consultation document (e.g. whether franchised passenger FTACs should be levied on a per mile basis). Given the detailed nature of some of the impact assessments, we are concerned that such proposals could be missed and would stress, therefore, the need for alignment between the impact assessments and ORR's future consultations.

Next steps

34. We note that ORR plans to conclude on this consultation in June 2017, and that there may be a follow-up consultation in mid/late 2017 on areas where ORR has not yet set out firm proposals (including the Capacity Charge).
35. We also note that ORR plans to consult industry on which market segments could be subject to mark-ups in CP6 in autumn / late 2017. We would encourage ORR to engage with industry on this work at an early stage and be clear on its process and approach.
36. Where there is sufficient clarity in ORR's June 2017 conclusions, we expect to consult with industry on the more detailed aspects of the charging and incentives framework for CP6 in summer 2017. This should allow industry and ORR to contribute to the detailed recalibration activities and considerations for each of the charges well in advance of ORR's draft decisions on charges and incentives in its June 2018 Draft Determination. If there is a delay in ORR issuing its conclusions on charges and incentives in June 2017, this is likely impact our ability to consult, as planned, in summer 2017.
37. We will also start considering if changes in access charges for CP6 are likely to require modifications to our billing systems and track and station access contracts (on which we would expect to work closely with industry and ORR).
38. The next year will be a critical time for detailed policy development for charges and incentives. We look forward to working with our customers, funders, ORR and other stakeholders during this period and in the lead-up to implementation of any changes at the beginning of CP6.

Structure of this response

39. The remainder of this response is split into two sections. The first section responds to ORR's detailed consultation questions. The second section provides comments on ORR's supporting documents, including the impact assessments published for some of the charging proposals in its consultation.
40. If you would like to discuss any part of our response in more detail, please contact Alexis Streeter (Alexis.Streeter@networkrail.co.uk) in the first instance.

1. Responses to ORR's consultation questions

Fixed cost charges

Question 1: Do you support our proposal to levy fixed cost charges on all operators, including open access operators, to the extent that they can bear them (option 2)?

Yes, Network Rail supports ORR's proposal (option 2) to levy fixed cost charges on all operators, to the extent that operators are able to bear these charges. We consider that this proposal has the potential to better align the costs that operators impose on the network with the charges that they pay. Where operators cannot bear these charges we believe that there should be a transparent subsidy to reflect this.

However, a robust assessment by ORR of the extent to which markets can bear fixed cost charges will be crucial to the success of this proposal. Therefore, we suggest that ORR starts engaging with industry in relation to this issue as soon as reasonably possible. We also note that ORR is planning to apply a consistent framework to the freight and open access operators' market can bear tests. At this early stage, we suggest not making any framework too prescriptive because the freight and open access markets are very different and this will need to be reflected in the assessments.

We are also mindful of the fact that this is a complex area. We, therefore, consider it important that when developing policy in this area that ORR and funders continue to be joined-up. For example, being clear how cost allocations, the market can bear test, the level of fixed cost charges, access rights, the NPA test, and the PSO levy all relate to one another.

We welcome the fact that ORR proposes basing the maximum level of fixed cost charges on the cost allocation work that we have commissioned. We believe that this work represents a step-change improvement in our understanding of the allocation/drivers of fixed costs and, therefore, should be used to inform the level of fixed cost charges. We also consider that there are potential benefits to be realised from increased transparency regarding who is 'responsible' for fixed costs, even if this information is not fully reflected in operators' charges. For example, it could provide additional information to funders in relation to the long-run cost impact of the services that they are specifying.

As noted, above, where a market segment (e.g. open access or freight services) cannot afford to pay all of the fixed costs allocated to it, we consider that this should be explicitly recognised in the form of a transparent grant from funders to Network Rail. At present, the costs attributable to freight and open access services are not transparent and are included in franchised passenger operators FTACs (or the grant income received by Network Rail in lieu of FTACs). This approach conceals the actual distribution of fixed costs within the industry and results in a 'hidden subsidy' to these market segments. If we want to maximise the benefits from this new more accurate allocation of fixed costs, we consider that it should be used consistently across the industry, including in relation to the allocation of network grant.

Approach to levying fixed cost charges

We welcome ORR's fresh thinking with regards to how our fixed costs could be recovered in CP6.

We note that ORR states that FTACs levied on franchised passenger operators "may become a per unit of traffic rate (e.g. a rate per train mile / vehicle mile, or another metric)"[1]. This would represent a significant departure from the current approach to levying FTACs (as a fixed lump sum each period) and any change in this respect would need to be considered very carefully.

We continue to consider that the incentives that we face to grow traffic could be improved and we are pleased that ORR recognises this issue in its consultation. We believe that this potential change to the FTAC could strengthen the financial incentives that we face to grow traffic. However, because this idea is only discussed at a high-level, it is hard for us to form a firm view on the impact that these proposals would actually have.

Whilst levying FTACs on a per mile basis would reduce the cost reflectivity of charges, it could also help improve our financial incentives to run more trains on the network. To the extent that traffic forecasts turn out to be incorrect (which they will because they are forecasts) we would receive (and operators would pay) more/less money than expected. Because most of our cost base is fixed, if traffic was lower than originally forecast the reduction in our income would be greater than the reduction in our costs. This would create, therefore, a shortfall in the money that we require to manage the network efficiently. It would also need to be taken into account in the assessment of allowances for risk.

The rationale for levying fixed cost charges on a per mile basis for freight and open access operators is that it would be impractical to charge them a fixed sum. The current freight fixed cost charges are levied on a pound per gross tonne mile because freight operators may win/lose contracts with their customers during the control period. If these charges were fixed, for each operator at the beginning of the control period, it would hinder operators' business models by making them highly operationally geared to traffic levels.

We are also mindful of the fact that open access operators do not currently pay fixed cost charges and, because of the uncertainty in relation to the effects that this will have, ORR may wish to levy any new charge on a per mile basis. This could help to mitigate potential affordability issues for open access operators because they would only pay charges when they run a train and receive revenue from passengers. We do not consider, however, that the rationale set out above in relation to freight and open access services is relevant to franchised passenger operators (i.e. passenger operators could continue to be charged a fixed charge).

We would also like to flag at this early stage that, if passenger FTACs were to be levied on a per mile basis, this would require development of our billing system to accommodate this change. The length of time required and cost impact of making changes to our billing system should not be underestimated.

[1] Footnote 3 on page 4.

We look forward to working with ORR to better understand its proposals in this area. We are keen, however, to stress that we are very open-minded about ORR's proposals.

Fixed cost freight charges

Question 2: Do you support our proposal to simplify the current charging regime by having a single freight mark-up charge?

Yes, Network Rail supports ORR's proposal to simplify the current freight charging regime by having a single-mark-up charge. Indeed, we suggested this in our response to ORR's first charges and incentives consultation.

We consider that a single mark-up charge would serve to simplify freight charges, making them easier to understand and administer. The Freight Specific Charge (FSC) and Freight Only Line Charge (FOLC) both make a contribution towards Network Rail's fixed costs. Therefore, if these charges were to be combined into a new fixed charge, the contribution from the freight industry towards our fixed costs would continue to be transparent.

We note, however, that in its consultation ORR indicates that the freight 'market can bear' test could involve considering how ability to pay varies by location. If applying the test in this way would lead to the geographic disaggregation of freight mark-ups, we would not support this change to the charging structure. We consider that any change in this respect would be inconsistent with ORR's proposal to simplify the current freight charging regime, and would make the charge disproportionately complex relative to the amount of money that it is likely to recover.

In addition, we would like to flag at this early stage that any geographic disaggregation of freight mark-up charges would require development of our billing system in order to levy the charge. As noted, above, the time required and cost impact of making changes to our billing system should not be underestimated, especially for more material changes (e.g. the geographic disaggregation of charges).

Question 3: Do you support the recommendation to apply Network Rail's cost allocation methodology (discussed in the chapter) to freight mark-up charges?

Yes, we support using the cost attribution work that we have commissioned to inform freight mark-up charges. As noted, above, we believe that this work represents a step-change improvement in our understanding of the allocation/drivers of fixed costs and, therefore, should be used to inform the level of fixed cost charges.

However, we recognise that there are good reasons for not always charging operators the full fixed costs that can be allocated to them. For example, if charging these costs would result in a significant switch in freight traffic from rail to road, with the loss of the environmental benefits that freight traffic generates.

Consistent with this, we consider that a robust assessment by ORR of the extent to which markets can bear fixed cost charges will be crucial to the success of this proposal. Therefore, we suggest that ORR starts engaging with industry on this issue as soon as possible. In addition, it will be particularly important that ORR considers the financial impact on freight operators in the round.

As discussed in our response to Question 1, above, we note that ORR is planning to apply a consistent framework to the freight and open access operators market can bear tests. At this early stage, we suggest not making this framework too prescriptive because the freight and open access markets are very different and this will need to be reflected in the assessments.

As noted above, where a market segment cannot bear the fixed infrastructure costs allocated to it, we consider that this should be recognised explicitly in the form of a transparent grant from funders to Network Rail. This grant would reflect the fixed costs attributable to a market segment, which are not recovered from train operators through charges.

Station Charges

Question 4: Long term charge: Do you support our recommendation that the methodology for the LTC at managed stations be recalibrated?

<u>Managed Stations</u>

Currently, the managed station long term charge (LTC) is set equal to the annual average of efficient forecast maintenance, renewal and repair (MRR) costs, based on a forecast of 100 years for operational property and 35 years for Station Information and Security Systems (SISS).

We consider that the LTC at a managed station should be set so as to recover, in the long run, all expected efficient MRR costs at that station. This long run approach is appropriate because it evens out the lumpy nature of MRR spending at these stations. In the absence of this long run approach, charges would be much more volatile.

A long run approach is also appropriate because the benefits of MRR work are seen over long periods of time. Without adopting a long run approach the costs of these works would only fall on current users, with future users not paying for any of the benefits that they enjoy.

Our approach to calculating the operational property element of LTCs for CP5 was based more heavily on local knowledge and reflected advances in our asset modelling capacity (compared with previous control periods). However, it did have limitations. In particular, the model did not take into account work carried out in previous control periods. The model also forecast costs to be zero over 100 years for a cost category where there were no expected costs in CP5.

On that basis, we support ORR's recommendation that the model used to forecast MRR costs for the LTC at managed stations should be recalibrated, in particular addressing the model limitations as described, above. Consistent with the comments made in ORR's draft impact assessment, we will ensure that stakeholders are kept informed of the likely implications of our proposed modelling improvements as the work progresses. We expect to provide further details in our summer 2017 consultation.

We would also like to highlight that the LTC is only intended to recover expected efficient MRR costs and that there are limitations to what can be achieved through the charging regime alone. We are currently undertaking a wider piece of work which is looking at raising standards at managed stations through better management models.

Franchised Stations

Although the consultation question relates to the managed station LTC, we would like to clarify that, we will not be proposing, and would not support, changes to the structure of the LTC at franchised stations. This is consistent with ORR's intention to focus on areas where there is a strong case for reform.

Our intention is to calculate franchised station LTCs consistent with the methodology used to calculate those charges for CP5 and we will discuss this further in our summer 2017 consultation.

Question 5: Qualifying expenditure: Do you agree with our recommendation that we support the work to make total QX charges more transparent at both managed and franchised stations?

We agree with ORR's proposal to support work aimed at making total QX charges more transparent at both managed and franchised stations. We think that this work can take place outside of the periodic review process and that greater transparency can be achieved before the start of CP6.

Consistent with ORR's draft impact assessment on QX transparency, we think that greater transparency of QX charges could have beneficial results. For example, the increase in available information could make it easier for operators to know whether any QX charges levied on them were likely to be cost reflective. This could lead to more informed negotiations between Station Facility Owners and operators and, over time, more efficient station operating costs.

However, like ORR, we recognise that QX figures could be misleading if published without supporting information which puts the figures into context. There are disparities between different stations which contribute to differences in QX between stations. Differences between stations include, but are not limited to:

- Differences in their area (m2) which contributes toward differences in QX because, all else being equal, one would expect the costs associated with providing services (e.g. cleaning) over a larger area to be greater;

- Differences in their usage (the number of entries, exits, and interchanges at a station) which contributes toward differences in QX because, all else being equal, one would expect the costs associated with operating a busier station to be greater; and

- Differences in the services offered by the station facility owner (SFO) at stations which contributes toward differences in QX because it means that there are costs recovered through QX at some stations that do not need to be recovered at other stations.

For this reason, it can be very difficult to make meaningful like-for-like comparisons between QX at different stations.

As noted in the draft impact assessment, we are planning on publishing on our website total QX charges for each managed station. Information about these charges will be accompanied by a document which will provide context for the figures and help to explain why QX differs between managed stations. This will possibly include a number of case studies looking at a range of managed stations and explaining QX charges at those stations. We will publish this information in due course.

We think that it is important to stress that managed stations are only a small proportion of the total number of stations across the network. Consequently we support greater transparency of QX charges at franchised stations too, which is necessary if the full benefits of QX transparency are to be realised.

QX Management Fee

We would also like to take this opportunity to confirm our intention to consult, in summer 2017, on the methodology used to calculate the management fee element of QX at managed stations for CP6.

The QX management fee for managed stations is the only part of the QX charge that is regulated and determined by ORR. The Independent Station Access Conditions require ORR approval of the management fee for managed stations before the start of each control period. The management fee is levied as a percentage of the fixed element of QX.

There are two parts to the QX management fee. The first part recovers central overheads in respect of operating, or procuring the operation of, the managed station.

The second part is a profit element, charged to reflect the risk we take on in providing the services covered under QX. For CP5 we undertook a benchmarking exercise to ascertain what would be an appropriate profit element. This benchmarking exercise considered QX charges at franchised stations, the management fee charged to retail tenants at managed stations and external advice from property experts.

For CP5, ORR approved a management fee of 6.54%. This consists of 1.54% to recover central overhead costs and a 5% profit element.[2]

In summer 2017, we expect to consult on: the costs we expect to include in the central overheads element of the QX management fee; and the results of initial benchmarking exercises to calculate an appropriate profit element.

Variable Usage charge

Question 6: Do you support our recommendation not to make fundamental changes to the VUC for PR18?

Yes, Network Rail strongly supports ORR’s proposal not to make fundamental changes to the structure of the Variable Usage Charge (VUC) for CP6. Indeed, we stressed the

[2] ‘Network Rail managed stations – decision on the approval of the qualifying expenditure (QX) management fee for control period 5 (CP5)’ available at: http://orr.gov.uk/__data/assets/pdf_file/0008/17792/2015-04-30-management-fee-decision-letter-cp5.pdf.

importance of retaining the current structure of the VUC in response to ORR's first charges and incentives consultation, particularly given other significant industry reforms (e.g. the introduction of route-based and System Operator regulation).

We understand that ORR was considering geographically disaggregating the VUC and using top-down econometric benchmarking to inform the level of the charge. Working closely with RDG, we explained to ORR why the industry did not support introducing these changes. We welcome the fact that ORR has taken on board feedback from the industry in relation to these two potential changes, and will not pursue them further in PR18.

Question 7: Do you have any suggestions for 'recalibration' style changes to the VUC you would like to see considered for PR18 implementation?

Network Rail supports the two recalibration style changes highlighted by ORR in its consultation document. Namely, we support reviewing:

1. Whether it continues to be appropriate to apply a single speed assumption in respect of each vehicle class when they operate over different routes with different maximum line-speeds.

2. Whether the vehicles characteristics which underpin CP5 VUC rates continue to be appropriate.

In relation to point one, above, we would like to work with the industry to make incremental improvements to the current charging arrangements. However, we would want to ensure that any changes do not create an undue burden on the industry (e.g. in terms of approving new rates) and that we are able to accommodate these changes in our billing system. We will discuss potential options for reflecting different speeds in VUC rates as part of our summer 2017 consultation.

As part of our summer 2017 consultation we will invite stakeholders' views on other potential recalibration style changes to the VUC for CP6. We also hope that this ORR consultation will help to identify potential changes that stakeholders would like to see implemented in CP6. We would be happy to discuss these other potential changes with stakeholders, prior to issuing our summer consultation. Generally, we consider that any recalibration style changes for CP6 should be proportionate in the wider context of not making fundamental changes to the VUC as part of PR18. Moreover, there will need to be sufficient time left in the periodic review process to evidence and implement any potential changes.

In addition to the recalibration style changes discussed, above, which will impact on the distribution of variable usage costs between different vehicle types, Network Rail also plans to review the 'level' of the VUC for CP6 (i.e. whether on average charges are currently too high or too low). Updating the level of the charge is part of the standard recalibration process at a periodic review. However, ORR has indicated that for CP6 it would not be possible to phase in any increases in the level of the charge unless these result from substantive methodological changes. This represents a significant change in approach from PR13 and could potentially have a significant impact on operators' charges.

An initial indication of the revised level of the VUC charge will emerge over the next few months, when we translate ORR's policy decisions and our PR18 cost forecasts into proposed access charges. It is possible that our revised PR18 cost forecasts could imply a significant increase in the level of the VUC for CP6 (e.g. as a result of increased unit rates). Any increase in this respect would be exacerbated by ORR's view that it would not be possible to phase in any increase to charges, and the unwinding of ORR's caps on the CP5 variable usage charges. We are very mindful of the fact that freight and open access operators' business models are vulnerable to increases in access charges. We are, therefore, planning to develop an initial estimate of the likely change in the level of the VUC prior to issuing our summer consultation and to share this with industry. If this analysis indicates an increase in the level of the VUC, it will be important for all industry colleagues to work together and consider how this could best be managed. It will also be important that ORR considers the impact of changes to the level of access charges in the round, rather than at an individual charge level.

Capacity Charge

Question 8: Do you support our recommendation not to replace the Capacity Charge with adjustments to Schedule 8 benchmarks?

Before addressing ORR's consultation question, we have set out some general comments and observations on the Capacity Charge. In particular, we think it is important to reflect on the findings from RDG's Review of Charges in relation to the Capacity Charge, as well as to consider the purpose of the Capacity Charge, prior to responding to specific options for the charge in CP6.

Prioritisation

During RDG's Review of Charges, it was agreed that the Capacity Charge was one of the areas that should be prioritised for review for CP6. We are concerned that this has not happened, and that the current options for the Capacity Charge are not particularly well-developed for this stage of the periodic review. This may impact on Network Rail's ability to undertake a recalibration of the charge for the beginning of CP6, if necessary.

It is important that ORR prioritises its work in this area. We are currently working closely with industry colleagues, through RDG, to develop a Capacity Charge, or similar mechanism, for CP6 that is workable and acceptable to all parties. We would welcome ORR's input into these discussions.

Purpose of the Capacity Charge

ORR has presented a number of high-level options for changing the Capacity Charge for CP6. It is vital that each of these options is assessed against the purpose of the Capacity Charge which is to recover Network Rail's additional Schedule 8 costs resulting from increased traffic on the network.

We are very concerned that ORR does not appear to assess the Capacity Charge options against this purpose. For example, in the consultation document ORR notes that the current Capacity Charge "is not well correlated with congestion on the network". It should not be expected that the Capacity Charge would achieve this. Whilst in general Schedule 8 costs are higher when congestion is higher (and therefore the Capacity Charge rates are higher), this is not always the case. The Capacity Charge is dependent on both congestion-related reactionary delay and the Schedule 8 payment rates which are very wide ranging since they reflect train revenues and not congestion. For example, we observe Network Rail payment rates for one operator that are five times higher than those for another operator on the exact same part of the network. It can therefore be the case that Capacity Charge rates are relatively low in congested areas, if the Schedule 8 payment rates in that area are low.

This lack of correlation with congestion should not be considered a failing of the current Capacity Charge, which achieves its stated purpose. Any charge that is purely based on congestion would be more of a 'scarcity charge'. Whilst the Capacity Charge may share some features with a scarcity charge, this is not its purpose. If ORR considers that there could be merit in introducing a scarcity charge, this should be openly discussed.

In addition to this, ORR's impact assessments of the Capacity Charge options note that the charges and incentives regime as a whole should ensure that Network Rail has the correct incentives to grow traffic. We agree with this statement, and believe that this should be a key consideration throughout the periodic review process. However, ORR then appears to assess the Capacity Charge on its own against this. The Capacity Charge should not be expected to achieve this on its own, and we do not consider it a failing of the Capacity Charge that it does not provide Network Rail with the correct incentives to grow traffic. We consider that the charges and incentives framework, as a whole, should be assessed against this objective. The Capacity Charge, like the other short-run variable charges, plays a very important function in holding Network Rail financially neutral to changes in traffic levels. If the Capacity Charge did not achieve this purpose, Network Rail would be financially penalised from accommodating additional traffic. The Volume Incentive aims to provide a financial incentive to increase traffic levels. There would be considerable merit in reviewing the effectiveness of the current Volume Incentive and whether it needs to be further strengthened to drive intended behaviours.

Phasing in / capping the Capacity Charge

In its consultation, ORR suggests that EU legislation relating to the calculation and implementation of costs directly incurred[3] applies to the Capacity Charge, which means that it cannot be capped or phased in for CP6. We understand that this legislation applies when calculating direct costs for the purpose of setting the charges for the **minimum access package** only. The consultation document sets out that costs recovered by the Capacity Charge do not fall within the scope of the minimum access package, so we do not consider that this legislation would apply to those costs. Therefore, if ORR's interpretation of the minimum access package is correct, the Capacity Charge should be treated as a mark-up, where the rules do not contain the same restrictions on caps or phasing in. This approach would mean that the industry has more flexibility when developing Capacity Charge options during the periodic review. It is important that ORR clarifies this matter as soon as possible.

[3] Commission Implementing Regulation (2015/909)

ORR's recommendation not to replace the Capacity Charge with adjustments to Schedule 8 benchmarks

We agree with ORR's recommendation to not replace the Capacity Charge with adjustments to the Schedule 8 benchmarks.

This option was put forward as part of RDG's Review of Charges, and we worked with industry (through RDG) to develop this idea further. However, during the course of these discussions, we identified a number of issues with the Schedule 8 benchmark adjustment approach which we do not consider can be overcome for CP6. We have set out the most problematic of these issues, below, and would be happy to discuss these with ORR if useful:

1. This approach would create a significant administrative burden for the industry, as Network Rail's benchmarks would need to be recalibrated more frequently during the control period than currently. These recalibrations would need to ensure, for example, that the star model (whereby all Schedule 8 compensation is passed through Network Rail) was balanced. It would also be difficult to determine which traffic should be accounted for in the adjustment to Network Rail's benchmarks. For example, it may not be appropriate to adjust Network Rail's benchmarks if there have been, or were expected to be, a large number of possessions.

2. Freight and charter operators would face a cross-subsidy as they current have a single, national Schedule 8 regime for all operators. When one operator increases their traffic, Network Rail's Schedule 8 benchmark would have to change for all freight/charter operators across the entire network, in order to maintain the national regime.

3. Adjusting the benchmarks of the operator increasing its traffic may mean that Network Rail does not fully recover its additional Schedule 8 costs. While it should be possible to neutralise the additional Schedule 8 costs for the operator increasing its traffic, it would only be possible to neutralise the effect on other operators by changing their Network Rail benchmarks. This is inconsistent with the purpose of the Capacity Charge.

4. With annual adjustments, there could be a time lag of up to one year before Network Rail's Schedule 8 benchmarks change to account for additional traffic.

We understand that some freight operators may still be attracted to this approach. However, and as noted above, in order for Network Rail's Schedule 8 costs associated with additional traffic to be neutralised, this would have to involve a change to all affected operators' benchmarks, including passenger operators. Without the adjustment to the Network Rail benchmarks for affected passenger operators, Network Rail would not be held financially neutral to changes in freight traffic levels. There could be merit in exploring this option further with freight operators, provided that Network Rail is held financially neutral to the increased Schedule 8 costs.

Question 9: Do you think we should: a) retain the existing CC (but remove the caps on open access, freight and charter operators); b) removed the existing CC and recover lost revenue through fixed cost charges; or c) do you have any alternative proposals?

The RDG Schedule 4/8 and Capacity Charge group is formed of a representation of RDG members across the industry. This group agreed that, in assessing the Capacity Charge or any alternative mechanism for CP6, the following principles should apply:

1. There should be, as far as possible, a predictable and stable charging regime for all operators.

2. Trains of a similar nature operating on the same parts of the network should have their various access charges set on a consistent basis.

3. Network Rail's incremental Schedule 8 costs of traffic growth above the control period baseline should be neutralised.

4. Any Schedule 8 cost consequences of running additional traffic should be reflected in that part of the network.

5. There needs to be an effective and transparent transmission mechanism to incentivise Network Rail to balance appropriately the costs and performance consequences of additional rail traffic.

6. Any alternative to the Capacity Charge should be workable and internally consistent – there should be no 'special arrangements' for CP6.

We strongly recommend that ORR assesses its options, and any future options that are developed for the Capacity Charge, against these RDG-agreed criteria.

In its consultation, in addition to the 'do nothing' option, ORR explores three high-level options for the Capacity Charge for CP6:

Option 1: Retain the existing charge, but remove caps for open access and freight (addressed under part (a) of this question)

Option 2: Replace the charge with adjustments to Schedule 8 benchmarks (addressed under our response to question 8)

Option 3: Remove the charge and recover lost revenue through higher fixed cost charges (addressed under part (b) of this question)

<u>'Do nothing'</u>
ORR assesses the 'do nothing' option against two objectives: "provide accurate incentives for Network Rail to add traffic to the network" and "ensure operators take costs of service into account when using the network". In the impact assessment, ORR scores this option as only partially meeting each of these objectives. We disagree with this assessment. The Capacity Charge holds Network Rail financially neutral (in respect of Schedule 8) to accommodating additional traffic, and so achieves the first objective well in the context of the charges and incentives regime as a whole (of course, the Capacity Charge alone could not

incentivise Network Rail to add traffic to the network). Also, the Capacity Charge exposes operators to the increased Schedule 8 costs that they create when additional traffic is added to the network. It therefore also meets the second objective.

Option 1: retain the existing Capacity Charge but remove the CP5 caps

This option would recover Network Rail's Schedule 8 costs associated with additional traffic on the network, and so would achieve the purpose of the Capacity Charge. It would ensure that Network Rail did not face a disincentive to accommodate additional traffic on the network. This option would also remove the current wash-up process, so would make the Capacity Charge less complex, reduce uncertainty of payments and make the charge easier to administer. On this basis, we support Option 1. However, we understand that this option may not be affordable for freight, charter and open access operators. It is important that the affordability of the whole charging regime is assessed for each type of operator, and not in isolation for each charge.

Option 3: remove the existing Capacity Charge

We are concerned that this option would not achieve the stated purpose of the Capacity Charge. It would result in Network Rail being financially penalised through additional Schedule 8 costs when traffic is above expected levels. As a result Network Rail could be financially very reluctant to accommodate additional traffic on the network. Without an adjustment to Network Rail's funding for the additional Schedule 8 costs it faces from accommodating above expected traffic levels, we cannot support this option. One way to overcome this, suggested by ORR, is to recover the 'missing' Capacity Charge income through the Volume Incentive. However, under this approach Network Rail would face a cash shortfall within CP6 since additional funding through the Volume Incentive would not be provided until the next control period. Furthermore, this would create a dual purpose for the Volume Incentive of both cost recovery and an incentive to growth traffic. We are unsure how effective this would be in practice. Below, we discuss our other concerns with this option.

We are concerned that this option is the preferred option for the Capacity Charge, according to ORR's impact assessment. In assessing this option, ORR has scored it neutrally, as "no change relative to the do nothing" against all of the specific and general objectives, on the basis that there is a large amount of uncertainty regarding mark-ups and therefore no other score could be provided. Given this high degree of uncertainty, we do not believe it is appropriate that this option is considered the "best option under each state of the world" in ORR's impact assessments.

In these impact assessments, ORR notes that the reduction in revenue from removing the Capacity Charge would be offset by an increase in the revenue recovered through revised fixed cost charges. This is not necessarily true. Fixed cost charges recover the fixed costs of running the network, and so it would be highly unlikely that these would bear any resemblance to Network Rail's additional Schedule 8 costs resulting from above forecast traffic. Furthermore, fixed cost charges would only be able to recover any costs relating to above forecast mileage if they were charged on a variable basis (e.g. per train mile). The additional Schedule 8 costs that Network Rail incurs relate to the traffic above forecast levels, and so this option would not work if ORR's proposal to charge fixed costs on a variable basis does not materialise. In addition to this, fixed cost charges will be subject to a market-can-bear test. This means that there is a possibility that certain markets will not be able to afford their full allocation of fixed costs. In this situation, Network Rail would need additional funding to ensure that its fixed costs, and additional Schedule 8 costs, are fully recovered.

Furthermore, ORR notes that this option could potentially replicate and possibly improve upon the incentives under the current Capacity Charge. We consider that this option would achieve neither of these. Fixed cost charges recover different costs from the Capacity Charge. With the removal of the Capacity Charge, operators would not consider the financial impact of Schedule 8 when planning new services. This proposal would therefore not improve upon the current Capacity Charge incentives. Fixed cost charges could also potentially set some very different incentives from those that ORR hopes to achieve from the Capacity Charge. For example, the initial work on fixed cost allocation found that the allocation of fixed costs to operators on heavily congested sections of infrastructure are often lower than in less congested areas (because of economies of scale).

Finally, this option for the Capacity Charge is largely reliant on ORR's early ideas on fixed cost charging being adopted for CP6. We are not clear whether or not these proposals will be taken forward. In fact, ORR notes that the option for fixed costs depends on the detailed design and implementation of the review of fixed cost charges which will not be known for some time. In light of this uncertainty, we would welcome ORR working with the industry to develop alternative approaches to the Capacity Charge for CP6 which do not rely on the approach to fixed cost charging. This should be a priority in the coming weeks.

Alternative proposals

Network Rail is working with the industry, through RDG; to develop alternative proposals for ORR's consideration (e.g. "£0 on baseline traffic", "Capacity Charge rebates" and "market-based wash ups", all of which are explained in detail in RDG's response) which we think are an improvement to the options that ORR has presented in its consultation. Please refer to the RDG response for further discussion of these alternative options. We would welcome ORR engagement in this process.

Traction Electricity Charge

Question 10: Do you support our recommendation to keep the loss incentive mechanism?

We consider that there would be merit in ORR discussing its proposals further with the industry before it concludes. We set out some observations below.

Management of transmission losses

In PR13, ORR stated that the intention of the loss incentive mechanism was to expose Network Rail to an additional share of the volume reconciliation (over and above the exposure we would get from our own use of traction electricity) in order to incentivise more efficient management of transmission losses.

ORR states "it is unclear whether the mechanism has had useful incentive effects" in reducing transmission losses. Interventions aimed at reducing transmission losses are expensive and the benefits are, in many cases, not sufficient to generate a positive business case for undertaking this investment, even taking a whole industry perspective. Therefore, we do not consider that the loss incentive mechanism has a strong effect with regards to this aim.

In addition, as ORR notes, the mechanism has had the unintended consequence of moving a small amount of money from modelled operators to Network Rail.

We do not agree with ORR's view that this is because there has "consistently been a big difference between actual and forecast losses in PR13". Instead, we think that the size and direction of the year-end volume reconciliation is mainly the result of modelled traction electricity consumption rates being inaccurate and, probably, too high. One way for train operators to respond to this would be for them to move from modelled to metered billing for their EC4T usage.

Increased on-train metering

It was also noted that the loss incentive mechanism could increase the incentive on modelled operators to adopt on-train metering in 'money-back' ESTAs[4].

We fully support on-train metering, having been involved in its initial stages and contributed to its subsequent developments.

We agree that the loss incentive mechanism could have provided an additional financial incentive for modelled operators to become metered. We are also aware of additional factors that influence whether train operators meter trains, for example franchise agreements.

Incentives to accurately forecast transmission losses

We do not agree with ORR's statement that the loss incentive mechanism incentivises Network Rail and relevant train operators to ensure that forecast losses are reflective of likely outturn losses.

The Distribution System Loss Factors (DSLFs) are charged as a mark-up on metered consumption and metered train operators are, therefore, in theory incentivised to argue that our transmission forecasts are too high. An estimate of transmission losses is included in modelled consumption rates and these are taken into account in the year-end volume reconciliation. As a result, train operators who are charged for traction electricity based on modelled consumption rates would benefit from higher DSLFs (all else being equal) as these higher rates would only be payable by metered operators. They are, therefore, in theory incentivised to argue that our transmission loss forecasts are too low.

Consequently, neither metered nor modelled train operators have a financial incentive to ensure that forecast transmission losses are reflective of actual outturn as metered

[4] 'Money-back' ESTAs are ESTAs where the modelled kWh that operators are billed in the financial year exceeds their actual consumption, leading to a decrease in the kWh consumption allocated to these operators in the year-end volume reconciliation and, consequently, a refund from Network Rail.

operators will prefer ‘low’ transmission loss mark-ups, whereas modelled operators will prefer ‘high’ transmission loss mark-ups.

We are currently undertaking work to forecast transmission losses for CP6 and to calculate the DSLFs to be applied to metered traction electricity consumption. We are carrying out this work in a transparent and collaborative manner. For example, we have given several presentations to the cross-industry Traction Electricity Steering Group and will continue to ensure stakeholders are kept updated as the work progresses.

Risk-sharing

ORR argues that the loss incentive mechanism “shares the risk of forecasting errors between Network Rail and those train operators with modelled (i.e. non-metered) consumption”. We interpret this statement as ORR meaning that it is forecasting errors in the transmission loss mark-up which is shared between NR and modelled operators. As noted previously, the transmission loss mark-up is only applied to metered operators – so, *prima facie*, it is metered operators who are most exposed to the risk of errors in forecasting the transmission loss mark-up.

The loss incentive mechanism has the effect of exposing NR to a greater proportion of the consumption that needs to be ‘washed-up’ in each ESTA at the year end, than would be the case if the wash-up was done purely based on modelled operators’ and NR’s estimated consumption. For each ESTA, NR’s share of the wash-up is increased by assuming all of the estimated transmission losses (for all consumption) in the ESTA are consumed by NR. This has the effect of reducing modelled operators' exposure to the risk of the transmission loss mark-up being wrong. Therefore, we consider that this leaves modelled train operators less incentivised to ensure that transmission loss mark-ups are accurate than would be the case in the absence of the loss incentive mechanism.

Therefore, we think that there would be merit in ORR engaging further with the industry to clarify the efficacy of the loss incentive mechanism before it concludes.

Traction Electricity Charge: Further considerations

Default modelled consumption rate

We would like to take this opportunity to confirm that it is our intention to consult on introducing a default modelled consumption rate for electric train services for CP6. The purpose of a default rate would be to: provide us with a contractual basis, where a generic consumption rate does not exist, for billing modelled services whilst waiting for a modelled consumption rate to be consented to / determined by ORR; provide an incentive for operators to apply for a modelled consumption rate at the earliest available opportunity; and provide us with a contractual basis for billing metered services whilst waiting for the relevant track access contract to be supplemented to allow for billing on the basis of meter readings.

There have been occasions where the process of obtaining a modelled consumption rate for a particular fleet has taken a prolonged period of time. We are concerned that were a modelled consumption rate not to be consented to / determined by ORR before the end of the relevant financial year and a generic consumption rate for the vehicle type concerned not to exist, we could have a situation where we would be unable to bill the fleet involved for its traction electricity.

There is a deadline of the end of the relevant financial year for modelled consumption rates to be consented to / determined by ORR because of the need to conduct the year-end volume reconciliation, which reconciles modelled consumption with actual consumption. Modelled consumption rates need to be agreed before we can start the volume reconciliation. Once the volume reconciliation has started we can no longer recharge journeys that took place in the financial year to which the volume reconciliation relates. If we were unable to bill a fleet for its traction electricity consumption, this could have an adverse impact on other modelled operators who are also in the volume reconciliation. In this situation, a default modelled consumption rate would mean that we would be able to bill these services for their use of traction electricity.

Furthermore, a sufficiently high default consumption rate would incentivise operators to apply for a modelled consumption rate at the earliest available opportunity. At present, modelled consumption rates frequently have to take effect retrospectively. Because there is often a lengthy delay between services first operating on the network and modelled consumption rates for these services being consented to or determined, we have to recharge a significant number of journeys. This is time-consuming, costly and could largely be avoided if modelled consumption rates were consented to or determined sooner.

In addition, a default modelled consumption rate would provide us with a contractual basis for billing metered trains for traction electricity whilst waiting for their track access contracts to be supplemented to allow for them to be billed on the basis of meter readings.

In this situation, we need to be able to bill operators for their traction electricity usage in the intervening period between the train beginning operations on the network and the necessary supplemental agreement being consented to / determined by ORR. A default modelled consumption rate would provide us with a contractual basis for billing services in this situation, without the need to undertake overly burdensome work to model consumption rates.

Regenerative braking discounts applied to modelled consumption rates

Modelled services which utilise regenerative braking are eligible to have a percentage discount applied to their modelled consumption rates. The discount that is applied varies depending on the type of infrastructure which the service operates on (AC or DC) and, on the AC network, according to the distance between station stops.

The discounts that are currently applied were set some time ago and on the basis of estimates. We now have a significant amount of data available from meters on-board trains that are capable of regenerative braking and, as discussed at meetings of the Traction Electricity Steering Group, we think that there is merit in using this data to recalibrate the regenerative braking discounts. We are currently undertaking this work and will share the results with ORR and industry in due course.

Electricity asset usage charge

Question 11: Do you support our recommendation that the EAUC not be altered, beyond recalibration, in PR18?

We support ORR's recommendation that the Electricity Asset Usage Charge (EAUC) is not altered, beyond recalibration, in PR18.

In its Review of Charges, RDG assessed the current charges and incentives regime. It found that industry was broadly supportive of the EAUC in its current form and that it was not considered a priority area for review.

We fully support RDG's Review of Charges work and, consequently, agree with ORR's recommendation.

Coal Spillage Charge

Question 12: Do you support our recommendation to abolish the CSC?

Yes, Network Rail supports ORR's proposal to abolish the Coal Spillage Charge (CSC).

We recognise that the coal traffic has declined materially in recent years, significantly reducing the impact of coal spillage and, therefore, the revenue that we receive through the charge. This reduction, from c. £3m in 2014/15 to forecast income of c. £0.2m in 2018/19, increases the likelihood of the work required by the industry to recalibrate the CSC becoming disproportionate. We also recognise that the incentive properties of the charge are relatively weak. For example, if an operator takes steps during the control period to reduce the amount of coal spillage from its wagons, this would not be reflected in the charge that the operator pays during the control period.

As noted in ORR's consultation document, although we support ORR's proposal to abolish the CSC, we would like to explore with freight colleagues a contractual approach to recovering spillage costs. This would allow us to claim under the track access contract for the actual costs that we have incurred cleaning up spillage from freight wagons. The proposed approach would apply to all commodities, rather than just being limited to coal spillage.

We envisage only being able to claim for spillage costs where we have appropriate supporting evidence in relation to the operator that was responsible for it. We want to ensure that operators continue to take steps to minimise spillage from their wagons on the network. Unlike the current charging approach, we consider that an improved contractual approach to recovering spillage costs would be more targeted and, therefore, have a stronger incentive effect. We are mindful, however, that any contractual processes for recovering spillage costs must be proportionate and avoid undue transaction costs, if they are to be successful.

Schedule 8

Question 13: Passenger compensation: What are your views on the options of passenger compensation recovery and improving the transparency of compensation relating to Network Rail's actions?

Network Rail is supportive of passengers getting better compensation when their train services have been disrupted. If passengers receive an appropriate level of compensation for disruption, we consider that this could reduce their reluctance to use rail in the future and therefore reduce train operators' future revenue losses.

We welcome ORR considering ways to improve how passengers do get appropriate compensation when their journeys are disrupted. However, we consider that the current arrangement by which train operators are responsible for all passenger compensation has considerable merit, as it means that train operators have a financial incentive to minimise disruption in all instances. It is also consistent with the basis on which they won their franchises.

<u>General comments</u>

If, however, ORR does conclude that Network Rail should make financial contributions towards passenger compensation, we consider that train operator's reduced future revenue losses should be reflected in Network Rail's Schedule 8 payment rates to reflect the fact that the compensated passengers would be less likely to put off from travelling by train in the future. However, calculating this effect will be very difficult to do accurately, and the existing Schedule 8 payment rates are already very hard to calibrate. In fact, we believe that some of the current Schedule 8 payment rates may already be too high, and could be considered to provide operators with too much compensation for their future revenue losses due to delays. Therefore, some of the existing Schedule 8 payments could be put towards paying for passenger compensation.

If, however, there were to be an increase in the compensation that Network Rail pays to train operators for delays, this additional expenditure will need to be reflected in Network Rail's CP6 regulatory settlement. Network Rail will not, otherwise, be able to afford this. Alternatively, a benchmark level of delays triggering passenger compensation could be set. For performance worse than the benchmark level, Network Rail would make payments to operators to cover their passenger compensation costs. However, this approach will increase the already significant financial risk to Network Rail of below benchmark performance.

We would also be concerned that paying for passenger compensation caused by Network Rail disruption could reduce train operators' financial incentive to take actions to help Network Rail reduce the impact of delays. Train operators are currently responsible for paying all passenger compensation, and therefore have a financial incentive to help Network Rail mitigate reactionary delays.

We understand that train operators have bid for their franchises on the basis of having to pay all passenger compensation. Therefore, we assume funders would need to adjust for any compensation payments to operators from Network Rail through adjustments to the franchise financial models.

Finally, we would be concerned if the inclusion of passenger compensation in the Network Rail performance regime in CP6 would change the nature of the relationships between Network Rail, passenger operators and passengers, particularly in the approach to how disruption is managed 'on the ground'. It might therefore be better for train operators to pay for all passenger compensation rather than introducing potential conflict through allocation between Network Rail and operators. We would welcome further discussion with ORR and industry about this.

<u>Recovering passenger compensation costs</u>

We agree with ORR's recommendation not to pursue a liquidated damages regime for passenger compensation. It would be highly complex to attempt to build this into the Schedule 8 regime, and creating a new liquidated damages regime would be difficult, inaccurate, costly and time consuming. Furthermore, ORR's proposal to not update the freight or charter operator payment rates in light of the additional compensation payment would leave Network Rail with a funding shortfall, which would need to be addressed.

We consider that a claims-based approach would have advantages over a liquidated damages approach. However, we are concerned that this could create a significant administrative burden on both Network Rail and operators. Network Rail would have a duty to ensure that operators' claims are appropriate before paying them, and so each claim would need to be carefully assessed. To do this, it would be necessary to verify the cause of the delay which has resulted in passenger compensation payments. This would be particularly difficult when a service experiences delays caused by multiple parties, and each of the delay incidents may not trigger a passenger compensation payment in isolation. There would also be additional complexities with this approach. For example, as there is not a standard passenger compensation regime which applies to all operators, Network Rail would have to verify passenger compensation claims based on differing regimes. This would complicate the process of verifying claims. Furthermore, there appears to be an imbalance in ORR's proposal, as operators would not be able to claim for passenger compensation payments as a result of delays caused by other operators.

In addition to this, we do not agree that Network Rail paying for passenger compensation would necessarily strengthen the financial incentives on Network Rail for dealing with disruption. Network Rail already faces strong incentives to improve performance through Schedule 8 and regulatory performance targets. Introducing an additional cost to Network Rail is unlikely to make a significant difference to our incentives. The significant money flows in the Schedule 8 regime already result in caution when accommodating additional traffic on the network or reworking timetables. An increase in the payments for disruption could serve to enhance this caution, and could create a perverse incentive whereby Network Rail may be reluctant financially to accommodate additional traffic.

Finally, we do not consider that discretionary payments to passengers, over and above standard compensation, should be included in claims for passenger compensation. This could result in vast differences in the payments that passengers receive for disruption, depending on which industry party has caused the delay. Network Rail would also face potentially high and volatile payments.

Improved transparency

We welcome any attempts to improve transparency about disruption on the railway. However, we would recommend that this transparency should also be extended to publishing passenger compensation payments as a result of the operator's own delay, and the delay caused by other operators, rather than only publishing the passenger compensation payments relating to Network Rail delays.

Question 14: Approach to setting benchmarks: Do you support our recommendation to only make changes to de-link passenger operators' benchmarks and Network Rail benchmarks for freight operators from past performance (but to leave the approach to the other benchmarks unchanged)?

Passenger regime

Aligning Network Rail passenger benchmarks with Network Rail's performance target

Network Rail supports ORR's proposal to leave the approach to setting Network Rail's benchmarks unchanged. Reflecting Network Rail's performance forecast that is reflected in ORR's Final Determination in the Schedule 8 benchmarks provides consistency on the level of performance Network Rail is expected to deliver. We consider that these forecasts would be set out in the relevant CP6 scorecard and accompanied by an appropriate degree of flexibility in the overall outputs framework to manage uncertainty and any potential changes that occur during CP6 (which Network Rail is exploring with ORR and industry as part of the outputs work for PR18).

However, we understand that the way in which our train performance forecasts are set for CP6 may be on a different basis from previous control periods, and this may affect how Network Rail's Schedule 8 benchmarks are set. Whichever performance forecasting approach is adopted, we recommend that Network Rail's Schedule 8 benchmarks are based on **a point estimate of performance which is forecast for the whole of the control period.** Most importantly, we need to ensure that the performance forecast which Network Rail is set for CP6 is reasonable and achievable. There are real difficulties in accurately forecasting performance several years ahead, and it is important that ORR recognises that Schedule 8 is therefore unlikely to be financially neutral, especially towards the end of the control period. Network Rail needs to be able to manage this significant financial risk, so it is important that the CP6 settlement provides Network Rail with an adequate mechanism to do so. For example, this could be increased debt headroom to cover the Schedule 8 financial risk. The quantum of this risk buffer should be informed by risk modelling. Without this, there is a significant chance that Network Rail could have to cut spending in other areas in order to meet its Schedule 8 obligations.

There are likely to be new performance metrics in CP6. The impact of this will need to be factored into the CP6 recalibration of Network Rail's Schedule 8 benchmarks.

Setting Network Rail and train operator benchmarks based on average network performance

We consider that introducing average Network Rail and train operator benchmarks would not result in an overall benefit to the industry compared to the current approach, and in fact may result in much worse outcomes. We have set out our reasons for this below. If ORR considers that the current approach to setting Schedule 8 benchmarks is inappropriate, we would welcome a discussion with ORR to understand the reasons for this and to explore alternative options.

Introducing average benchmarks for Network Rail and train operators would have the following issues:

a) **Cross Subsidy** between train operators and funders

Setting train operator and Network Rail benchmarks based on average performance across the network could lead to potentially large cross subsidies between train operators and, in some cases, funders. This is because the change in approach to setting the benchmarks would mean that, inevitably, some operators would face additional Schedule 8 payments, despite performing at reasonable or expected levels. These additional Schedule 8 payments would be offset by other train operators benefitting from a benchmark which is lower than their expected performance levels, resulting in a cross-subsidy between the two operators or their funders.

Similarly, the average benchmark approach would be inconsistent with route devolution as funds would need to be ‘moved’ between routes to balance Schedule 8. Additionally, the financial performance associated with Schedule 8 would be recorded against targets set out in Network Rail route scorecards, which will be agreed with our customers, and could show large over or under Schedule 8 payments even if performance was at expected levels.

This approach would therefore create a lack of transparency about how operators and Network Rail are performing compared to industry expectations. It is also unrealistic to expect the same level of performance to be achievable in each service group across the network, because of differences in service patterns, geography and infrastructure.

b) **Misalignment of incentives**

As part of our Transformation Plan, a key focus in CP5 and going forward is to align our targets with our customers’ targets. As stated in the plan, it makes profound sense for all parts of the railway to be working to consistent targets. Currently there are many different performance targets across the industry, for example franchise performance targets, Network Rail’s regulatory performance targets and Schedule 8 benchmarks. There is a limited degree of alignment between these measures currently. Network Rail benchmarks are linked to Network Rail’s regulatory performance targets, however franchise performance targets are not aligned to either Network Rail’s regulatory performance targets or the Schedule 8 benchmarks for Network Rail or operators. The lack of consistency in performance targets can act as a barrier to improving performance, as each party is targeted on, and aiming to achieve, different levels of performance. Setting the Network Rail and train operator benchmarks at the same level for all service groups would exacerbate this issue, since the average benchmarks would not align well to other performance measures for each train operator, or in each geographical area. This approach would, therefore, not be consistent, nor would it support the desire to align industry incentives going forward.

This approach would also send the wrong signals to industry parties about expected performance levels and would substantially weaken incentives to outperform benchmarks, since they would not reflect an achievable or representative level of performance for the majority of service groups.

c) Impact on the **recalibration of Schedule 8**

We believe that the Schedule 8 regime should be financially neutral to all parties if expected performance levels are achieved. We are concerned that ORR's proposal of an average benchmark for all service groups would not achieve this. It would not be possible for train operators to be held financially neutral for expected performance levels, as it will depend solely on how they perform compared to the network average. Similarly, average train operator benchmarks would make it difficult to ensure that Network Rail remains financially neutral through the star model to train operator-caused delays. Finally, it would be very difficult to ensure that Network Rail is held financially neutral provided it achieves its regulatory performance targets, and recalibrating to achieve this would be no simpler than the PR13 recalibration. If financial neutrality could not be achieved, this would need to be reflected in Network Rail's CP6 funding settlement.

This approach would also affect mid-control period Schedule 8 recalibrations. During the control period, we recalibrate Schedule 8 to ensure that train operators and Network Rail are held financially neutral to changes that would affect performance, for example for a significant timetable change (e.g. due to changes in franchises) or a berthing offset change. Network Rail is concerned that implementing average benchmarks in Schedule 8 could make it difficult to continue to ensure train operators and Network Rail are financially neutral to these changes. It would be important to establish, upfront, how we deal with this situation in CP6. One option would be to not recalibrate the benchmarks to account for these changes mid-control period; however train operators and Network Rail would be exposed to the Schedule 8 payments for these changes. The second option would be to recalibrate the affected service group's benchmarks, as we do currently. This would ensure that both parties are held harmless to the changes, and so would better uphold the purpose of Schedule 8. However the benchmarks would no longer be the same and the intention of the average benchmarks would be lost.

Aligning train operator benchmarks to franchise targets

We consider that there could be benefit in aligning train operators' benchmarks to train operators' franchise performance targets. Network Rail is not funded to deliver the level of performance set out in franchise targets, and so it would be inappropriate to align Network Rail's benchmarks to the franchise targets.

a) **Consistency in approach** to setting benchmarks

Currently operator benchmarks are set based on past performance, and therefore their benchmark is set at a level of performance they have proven to deliver for a sustained period of time. Conversely, Network Rail's benchmarks are currently aligned to CP5 performance targets, which are an aspirational level of performance which has not yet been achieved. Aligning train operator benchmarks to franchise targets would provide greater consistency in the approach to setting benchmarks. In turn, this may also provide a stronger incentive for train operators to improve performance.

b) **Aligning incentives**

With regards to performance levels, operators are currently targeted on franchise performance targets and their Schedule 8 benchmarks. These are not currently aligned. Aligning train operator benchmarks to their franchise targets would help resolve this issue by providing train operators with a consistent level of performance that they are expected to deliver. It is also possible that this would better align with Network Rail's regulatory performance forecasts, since a key focus of our Transformation Plan is to better align our, and our customers', targets. Specifically, in our Transformation Plan we committed to "work with DfT to create franchise targets that are aligned with Network Rail targets". However, we note that our performance forecasts will not always align with franchise performance targets, as these may not always represent the latest view of an achievable level of performance for Network Rail. As noted above, it is important that Network Rail's benchmarks are set at a reasonable and achievable level.

This option would greatly help with the current misalignment of incentives, as mentioned in the section, above. Network Rail would, therefore, support further consideration of this option by ORR and industry colleagues.

Other areas

Network Rail believes that there could be merit in reducing the number of decimal places currently used in the Schedule 8 benchmarks in the passenger regime. Schedule 8 benchmarks are frequently recalibrated during the control period, for reasons noted previously, which can result in minor changes to benchmarks. Reducing the number of decimal places from four to three, for example, would remove the need for recalibrating so frequently, therefore saving industry time and resources. The financial impact of implementing this approach would be minimal; if national performance on a day changes by 0.0001 minutes of average lateness, the daily cost per service group is less than £1. It is also important to note that using four decimal places implies a level of forecasting accuracy which may not be realistic.

Freight and charter regime

Aligning Network Rail freight benchmarks with the Network Rail's performance target

As noted in our response to ORR's letter inviting input to the review of Schedules 4 and 8 track access contracts, Network Rail supports ORR's proposal to align Network Rail's Schedule 8 benchmarks with Network Rail's performance target in CP6 as this would create consistency between Network Rail's targets for freight performance. As mentioned above, we consider that these targets would be set out in the relevant CP6 scorecard and accompanied by an appropriate degree of flexibility in the overall outputs framework.

We have undertaken some analysis to examine the relationship between the Freight Delivery Metric (FDM) and Schedule 8 delay minutes per 100 miles, and found that there is a robust relationship between the two measures. In light of the changes to the regime proposed, it is important to consider the expected financial impact of these changes on freight operators.

This approach cannot be replicated for charter services, as Network Rail does not have a performance target for charter operators. We therefore believe that Network Rail's charter benchmarks should continue to be based on past performance.

Continuing to base freight operator benchmarks on past performance

Network Rail is supportive of ORR's proposal to continue to set freight benchmarks based on average freight industry performance during the recalibration period.

Question 15: Measure of passenger operator performance: Do you support our recommendation to change the measure of passenger operator performance to one based on the delay caused to other operators?

We support ORR's recommendation to change the measure of passenger operator performance to one based on the actual delay caused to other operators (i.e. TOC-on-TOC), subject to it being possible to implement through PEARS. Network Rail is currently investigating whether this change is feasible and can be implemented ready for the start of CP6.

We understand that some operators may be concerned that this proposal may dampen Network Rail's incentives to manage reactionary delay on the network. However, we do not consider that this would be the case. Network Rail faces strong incentives on performance improvement, other than the Schedule 8 regime, for example target performance measures used in route scorecards (i.e. including disruption caused by parties other than Network Rail).

Furthermore, it is important to recognise that train operators already pay for the modelled impact of their own disruption on others in the current Schedule 8 regime. Therefore, ORR's proposal would not change what train operators pay for through Schedule 8, it would instead make this payment more reflective of the actual impacts, and therefore more accurate.

Benefits of proposal

We have discussed this option with ORR and the industry previously, and we believe that this will bring about many benefits in addition to those already identified by ORR. For example:

- This would address one of the 'gaps' in the performance regime, identified through RDG's Review of Charges. RDG identified that "the performance regime does not encourage joint working, since operators who help out another operator to recover their service are penalised…"
- Informational benefits, as train operators would better understand how their delays affect other operators. We would work closely with train operators to help them

understand this information. This information could be used to inform discussions with Network Rail about resilience planning. We expect that these informational benefits will mean that train operators take a greater interest in understanding which of their services are likely to be high-impacting on other operators (similar to how Network Rail has identified which of its assets cause most delays if they fail). TOCs could then work especially hard to ensure that these services do not cause disruption. We have included some examples of what train operators could do to minimise disruption caused by these high-impacting services (and other services which they run), below:

  - Train operators may ask Network Rail to prioritise services other than their own. The current "TOC-on-Self" arrangement is likely to incentivise train operators to minimise the disruption on themselves only, regardless of the knock-on impact of this. The proposed regime would encourage train operators to be more aware of the knock-on impacts of their own delays. For example, if a TOC A train is delaying a TOC B train, the best thing to do for overall delay may be to either cancel the TOC A service or allow the TOC B train to overtake, if this is possible.
    In fact, one of the issues with the current "TOC-on-Self" regime is that train operators have to pay through Schedule 8 for cancelling their own services, even if this does not cause any reactionary delay to others. ORR's proposed approach would not require train operators to pay for a cancellation of their own service if there was no knock-on disruption. Additionally, and as train operator colleagues have pointed out, train operators already have many incentives to minimise the disruption they cause to themselves (e.g. through franchise agreements and their own revenue).
  - Train operators may become even more interested in timetable planning, to ensure a robust timetable that minimises the impact of overall delay (including other operators' trains) rather than just accommodating as many trains on the network as possible.
  - Train operators may put in place better operational plans to deal with reactionary delay when it does occur. For example, having additional train crew on 'stand-by', investing in more reliable trains etc. Freight operators already do this, partly due to their FOC-on-Third Party Schedule 8 regime. This could especially be the case for the train services that have been identified as being especially likely to cause significant delay to other train operators' services.
  - There may be improvements to passenger communication if delays do occur, to ensure passengers are waiting at the correct platforms on stations and so can board the train quicker thus facilitating fast despatch.

- ORR's proposal does not just improve incentives. It would also ensure a better neutrality of payments through the star model. Current estimates suggest that Network Rail incurs costs of c.£15m p.a. due to the star model not being 'balanced' (i.e. Network Rail pays out more for TOC-caused disruption than train operators pay to Network Rail). Network Rail is not funded for these costs, and so must reduce activities in other areas to fund this shortfall. Better alignment of the star model will be particularly important for CP6, as there have been, and will continue to be, significant timetable changes during CP5 due to multiple franchise re-mappings. These changes would mean that the current approach (of train operators paying Schedule 8 based on a pre-determined level of reactionary delay) will be very difficult to accurately calibrate for CP6.

We believe that ORR's proposal may help drive better conversations within train operators and with Network Rail. This could then lead to more informed 'high level' decisions to deal with the impact of delays and to provide a better service for passengers. For example, through better conventions for train regulation.

Systems changes

As ORR mentions in its impact assessment, if this proposal were to be pursued for CP6, it would be necessary to update PEARS[5] such that it can process the potential new basis of train operator payments. It is intended that PEARS will be updated for CP6 anyway, so this change could be made as part of that update.

Delay attribution

Moving to a TOC-on-TOC regime may impact on delay attribution. The suggested change to the regime could result in train operators engaging more in delay attribution for reactionary delay that they have caused. This additional engagement could result in better and more transparent delay attribution, which in turn could allow Network Rail and train operators to identify performance improvement measures. However, we should also be mindful that there may be an increased number of challenges to delay attribution due to the financial incentive, and that this may require some additional industry effort.

Understanding

We recognise that this approach may make the Schedule 8 calculations more difficult to understand, as operators' payments would depend on multiple interactions with other operators, rather than just the lateness they cause themselves. If this approach were to be taken forward, we would work closely with operators to ensure they have the information needed to be able to understand the new calculations.

Question 16: Sustained poor performance provisions: Do you support our recommendation to limit SPP to costs compensation only?

We strongly support ORR's recommendation to change sustained poor performance (SPP) provisions such that claims may be made for costs only. We consider that this change could bring several benefits to the SPP mechanism, for example it could vastly reduce the amount of industry time and resource spent on processing each claim. We also note that ORR hosted an industry workshop in summer 2016 on Schedules 4 and 8, in which it raised the idea of SPP being for cost compensation only. At that workshop, there was strong industry support for this proposal.

[5] PEARS is the Network Rail performance reporting system, which calculates the Schedule 8 payments.

Alongside this change, we believe that it would be appropriate to change the SPP thresholds. Currently, the SPP thresholds are set based on Schedule 8 compensation payments from Network Rail, which reflect train operators' revenue losses. The current thresholds, therefore, bear little resemblance to the claims that could result from this change to SPP, and it would not be appropriate to use these as a trigger for cost compensation claims. We believe that the SPP threshold for a cost-only mechanism should reflect the following:

- The level of performance, below which train operators' costs are substantially different from those typically incurred as a result of 'normal' fluctuations in performance.

- Only the most extreme periods of poor performance. Changes in performance as a result of 'normal' performance fluctuations, such as seasonality (weather), should not trigger the SPP thresholds.

The original intended purpose of the SPP mechanism was to act as a safety net to protect operators against extremely poor performance by Network Rail over a sustained period. We do not consider that the SPP mechanism has worked in the way intended. The reduction of the trigger threshold to 10% from CP4 has meant that Network Rail can be technically in breach of the SPP trigger even as a result of only small fluctuations in performance (broadly speaking, a 10% fluctuation from benchmark performance roughly translates to a PPM movement of 0.5%). For example, SPP has previously been triggered by extreme weather in January and December of the same calendar year (i.e. within the same 13-period measurement timeframe) but where performance has otherwise been near to (or better than) benchmark over the year as a whole. Since the start of the control period, more than half of all operators have triggered SPP. Having a large number of train operators in SPP introduces a risk that the liquidated sums nature of the Schedule 8 regime is undermined. In addition to this, we have provided evidence to ORR which shows that the processing of an SPP claim introduces a disproportionate burden on industry resource with a correspondingly adverse impact on industry relationships, owing to their complexity and high financial value of claims. The claims necessitate the involvement of the most senior directors in both parties, and the engagement of expensive legal resources and consultants which even then does not facilitate easy resolution.

Therefore, if ORR decides not to limit SPP claims to cost compensation only, there would still be considerable merit in reviewing the current SPP thresholds. In order to justify the time and resource involved in each SPP claim, we consider that it is vital that the SPP threshold reflects the level of performance at which train operators' costs and revenue losses are substantially above those provided for in formulaic Schedule 8 compensation. We have previously recommended to ORR a SPP threshold of 30%[6], and still consider that this would be a more appropriate threshold for SPP.

[6] This is based on a report for SDG, which is available at: https://www.networkrail.co.uk/wp-content/uploads/2017/02/Sustained-Poor-Performance-final-Report.pdf

We also note that ORR has suggested revisiting the clarity of the contractual wording for SPP. As part of this review, we would welcome ORR considering introducing a time limit on claiming SPP for CP6, and note that this suggested change was supported by the industry at ORR's summer 2016 workshop on Schedules 4 and 8. The contractual wording should also reflect the suggested change to make the SPP mechanism relate to cost compensation only. Finally, we note that ORR consulted on the scope for claims during PR13. At the time, ORR concluded that it would not be possible to identify all types of claims that could arise, and so listing these (or the exclusions) in the contract may prevent some costs (or losses) from legitimately being claimed. Unless ORR now has better evidence of costs or losses that could be claimed or a more comprehensive list, we suggest that amending the contractual wording, in this regard, is not pursued again during this periodic review. However, we would welcome ORR issuing some SPP guidance which could include a list of examples of the types of costs or losses that operators could claim for. This guidance note could be updated as more examples come to light, and would not be contractually binding for either party.

Schedule 8: Further considerations

In addition to ORR's consultation proposals, we consider that there are other areas of Schedule 8 that could be improved for CP6. We would welcome the opportunity to explore these options with the industry.

Payment rates

It is important that the Network Rail payment rates are correct so that operators receive appropriate compensation for delays they do not cause. Correct Network Rail payment rates, that accurately reflect the effect of unplanned delays on long term operator revenues, de-risk franchises. This also avoids sending perverse incentives if operators over-recover from Network Rail through too high Network Rail payment rates.

In addition, Schedule 8 Network Rail payment rates also determine Schedule 4 revenue compensation rates. We are concerned that if Network Rail payment rates in Schedule 8 are 'wrong', this could distort the costs of taking possessions on the network.

a) Review of London and South East payment rates

Network Rail believes there is merit in reviewing the Network Rail payment rates for London and South East commuter services in PR18. These payment rates were reviewed by ORR in PR13 following the PDFH version 5.1 update, and ORR then expressed concerns about the payments rates for London and South East commuter services. ORR applied a downward adjustment of 10% to these services payment rates, to reflect "some of the issues Network Rail raised in relation to crowding dampening the impact of performance on demand and the longer time period between poor performance occurring and it having its full effect on revenue". However this adjustment was at an arbitrary level. We therefore believe PR18 provides an excellent opportunity to review these payment rates to ensure they are appropriate.

Network Rail commissioned an econometric study to investigate the relationship between unplanned delays and passenger demand (and consequently, operators' revenues), to improve industry understanding. The study found that: "The tentative implications of our analysis are that – at least for … London commuters – changes in lateness do not appear to cause significant changes in demand (and by extension, operator revenue). Such effects are only seen for journeys for which commuters have a choice between the train and the London Underground – and in the [study], these journeys only account for less than 5% of fare revenue.” This could be partially due to the dampening effect of crowding on the relationship between unplanned disruption on long-term revenue loss. Services in the London and South East area are often busy and are unlikely to have additional capacity to accommodate the additional demand that is suggested by the Network Rail rates when performance improves.

The consultants also recommended that: “…significant additional work is required to develop a more robust dataset and model, before any weight should be placed on these results. We have therefore made detailed recommendations for further work.”

In light of the recommendations from the initial study, PDFC is extending the analysis to include passenger demand and revenue data from a number of train operators. We strongly believe that the findings of this study should be considered by ORR and, if robust, reflected in the Network Rail payment rates for London and South East commuter services.

Splitting reactionary delay

Reactionary delay is an important issue on the network (around 70% all of delay on the network is reactionary) and therefore can have a significant impact on the end user. Reactionary delay can be influenced by both the train operator and Network Rail and is in many ways detached from the primary source and responsible party for the original delay.

If ORR decides not to pursue its TOC-on-TOC proposal, we consider that fresh thinking to address the lack of incentives for joint working for all reactionary delay should be explored.

One option to address this lack of incentives could be to share ‘financial responsibility’ for all reactionary delay. We note that we have not discussed this idea beyond Network Rail, but think that there may be merit in exploring this idea further if ORR does not pursue its TOC-on-TOC proposal. Sharing ‘financial responsibility’ for reactionary delay could help encourage operators and Network Rail to work together to minimise this delay and therefore improve passenger experiences. We believe that the attribution of all reactionary delay could be split between operators and Network Rail to acknowledge that both Network Rail and operators can play a role in reducing reactionary delay. Changing the approach could also simplify the current process for resolving disputes for delay attribution, through reducing the number of disputes and the requirement on industry resources to attribute and resolve delay disputes. This approach would not result in any increase to the administrative burden on the industry.

We also consider that there could be merit in sharing ‘financial responsibility’ for incidents on the network where it is not clear that one party is wholly responsible for the disruption, for example suicides.

Schedule 8 recalibration

The timely conclusion of policy decisions by ORR is vital in order to be able to recalibrate the Schedule 8 regime for CP6. Under the assumption that RDG will be leading on the recalibration, the ITT for the recalibration of Schedule 8 will need to be issued in August 2017, with consultants selected in early October 2017. It is important that ORR concludes on key policy decisions that affect the recalibration of Schedule 8 prior to August 2017. In particular, the following issues need to be rapidly concluded upon:

- Approach to setting benchmarks (for both Network Rail and operators).
- Measure of passenger operator performance (proposal to move to a TOC-on-TOC regime where performance is based on the actual delay caused to other operators).
- Payment rates, specifically for London and South East commuter service groups.

Freight operator incident caps

We consider that there would be merit in reviewing the incident caps within the freight operator Schedule 8 regime. We understand that these incident caps provide important protection to freight operators' businesses. However we are concerned that, when actual delay minutes caused by freight operators exceed their cap, the incident caps may limit freight operators' financial incentives to help mitigate this delay. We would welcome further discussion on this issue, and consider that ORR's Schedule 8 recalibration working groups could provide a good opportunity for this.

Schedule 4

Question 17: Do you support our recommended prioritisation of schedule 4 issues? If you think we should reconsider any of the areas we have de-prioritised please submit supporting evidence.

We agree with ORR's recommended prioritisation of the Notification Discount Factors (NDFs) in Schedule 4, and are content with ORR's recommended de-prioritisation of passenger and freight operator cost compensation, cancelled possessions and the scope of incentives. It is important to use industry resource sparingly, and that changes are only made when robust evidence is provided to support change.

This section sets out our thoughts on NDFs, and areas where we consider that the prioritisation may not be appropriate.

Incentives created by Notification Discount Factors

We support ORR seeking to better understand how passengers respond to different levels of notice of planned disruption. In any compensation regime, it is important that the level of compensation is based on robust evidence and is up to date. We consider that ORR's work in this area will ensure that Schedule 4 compensation reflects the losses that operators experience as a result of planned disruption.

In ORR's supporting document on the incentives created by NDFs, it frequently mentions that changes to the NDFs would initiate changes in Network Rail's possessions planning processes. However, a change in the NDFs may not be substantial enough to drive significant changes in the possessions planning processes. In fact, in the majority of cases, Schedule 4 is only one factor that Network Rail takes into account when planning possessions. There are a number of reasons for this:

1. Possessions planning decisions are often made based primarily on the logistics of the possession, rather than the Schedule 4 costs. For example, if the machinery cannot get to the work site, the work cannot go ahead.

2. Network Rail works to access planning timescales, which are separate from Schedule 4, and which govern how far in advance work must be planned. These access planning timescales tend to take precedence over Schedule 4.

3. Schedule 4 costs can be low in a lot of cases in comparison to other costs of undertaking engineering work. The other cost drivers may therefore be more important when planning the possession. However, we recognise that in some situations the Schedule 4 costs are significant.

In spite of the above, we continue to be of the view that updating evidence to inform Schedule 4 compensation would be beneficial to the industry.

Approach to ACS calculation

We do not support ORR's suggested changes to the Schedule 4 Access Charge Supplement (ACS) and, therefore, consider that the current approach should be retained. The reasons for this are set out below.

In considering a change to the Schedule 4 ACS, it is important to recognise the scale of the issue. The Schedule 4 ACS is currently only paid by franchised passenger operators, and the full cost is a direct pass-through to funders. While the value of the current Schedule 4 ACS may be considered to be quite high (c. £400m for the first 2 years of CP5), over this same timeframe Network Rail has paid out in excess of £600m in Schedule 4 payments to operators[7]. Therefore, it is the difference between these two figures that is actually the most important.

[7] This figure includes Schedule 4 payments for enhancement projects, which are not included in the Schedule 4 ACS.

ORR suggested three options which it considered would improve the accuracy of the Schedule 4 ACS:

Option 1: Estimate the ACS on the basis of the delivery plan produced immediately prior to the start of the control period

Option 2: Annual recalculations to adjust the ACS for business plan variations in the volume of maintenance and renewal activity during the control period

Option 3: Retain the existing methodology but subject to a high level adjustment to the total ACS needed

Each of these options would involve setting the Schedule 4 ACS on a basis which would be inconsistent with the assumed level of maintenance and renewals (M&R) volumes for CP6, as set out in ORR's Final Determination. It is important that Network Rail receives a funding settlement that allows it to deliver its M&R volumes and we are concerned that these three approaches would not achieve this.

We are firmly of the view that the Schedule 4 ACS must be aligned to the M&R volumes set out in the Final Determination and are an important part of the periodic review 'package'. These M&R volumes drive costs other than the Schedule 4 costs associated with possessions (for example, the costs of materials, labour, and planning the work itself). Network Rail's funding for each category of these costs should be set on a consistent basis, to ensure a balanced and appropriate funding settlement for CP6. If ORR is concerned that Network Rail will not achieve the M&R volumes that it sets out, it should address this holistically, rather than adjusting one element of the funding for this work. We also note that ORR already takes account of deferrals of work in its annual assessment of Network Rail's financial performance. We do not consider that ORR should also address this potential issue through adjusting the funding provided through the Schedule 4 ACS before the start of the control period. Not only would this prejudge the outcome of potential deferrals in CP6, but by adjusting our financial performance for any actual deferrals, this would account for the issue twice.

More specifically, ORR's suggestion to recalculate the Schedule 4 ACS annually (option 2) would have the effect of 'reopening' Network Rail's control period funding for one element of M&R costs. If ORR does take this action, it would appear to throw into question why ORR does not reopen other elements of the regime annually, when they go against Network Rail (for example, when Network Rail makes significant Schedule 8 payments to train operators). We also do not consider that ORR's suggestion to make a high level adjustment to the total ACS (option 3) would be appropriate. Adjusting future Schedule 4 ACS payments to reflect past delivery of M&R volumes may weaken the potential incentive effects associated with Schedule 4. If Network Rail is able to deliver a more efficient approach to looking after its assets, against its plan for the control period, then the ACS could be higher than the Schedule 4 payment to operators. Network Rail should not be penalised in future funding settlements in light of such efficiency.

In light of the above, we do not consider that ORR's suggestions for the Schedule 4 ACS represent an improvement to the current ACS, and could potentially lead to worse outcomes. However, we do consider that there could be merit in updating the underlying approach to forecasting Network Rail's expected Schedule 4 costs, and therefore the ACS. We are currently exploring options for this which we believe may improve the accuracy of the Schedule 4 ACS for CP6. We hope to discuss that with ORR and industry at one of ORR's upcoming Schedule 4 and 8 Recalibration Working Groups.

Bespoke compensation for major disruptions

a) Sustained Planned Disruption (SPD)

Network Rail agrees that it would be useful to review the access contracts for SPD and to have better guidance in place on the compensation process for SPD. However, we do not consider that the lack of SPD claims in itself means that the SPD mechanism is not working effectively. There are a number of reasons why operators may not claim for SPD:

- Operators may already be sufficiently compensated for the impact of possession on long term revenue loss through normal Schedule 4 payments.

- Type 2 (>60 hours) and Type 3 (>120 hours) possessions are the most disruptive possessions on the network, and are most likely to contribute to an operator triggering SPD. Operators are already able to claim for actual costs for Type 2 possessions and actual costs and revenue losses for Type 3 possessions through the standard contractual mechanism. The table below shows that there have been a number of bespoke Type 2 and 3 claims that have been settled in the past few years. Operators in SPD may therefore have already recovered actual costs and revenue losses through the standard compensation arrangements. Therefore an SPD claim is only likely to cover the actual costs and losses associated with Type 1 possessions (<60 hours). These are less likely than other possessions to result in significant additional costs and losses to train operators.

Number and value of bespoke Type 2 and 3 claims settled since 2013.[8]

	Number of bespoke Type 2/3 claims	**Value of bespoke Type 2/3 claims**
Settled in 2013/14	16	£3.0m
Settled in 2014/15	27	£17.5m
Settled in 2015/16	29	£26.9m
Settled in 2016/17 (year to date)	19	£24.2m

Network Rail does not support ORR's view that the SPD thresholds are too high and therefore do not capture the most disruptive possessions. SPD is designed to apply only in extreme cases where the standard Schedule 4 compensation is not sufficient. SPD is claims based and uses significant industry resource. Therefore it is important that only the most disruptive possessions are included in SPD. Any change to the thresholds should consider the scale of impact on limited industry resources, and should be reflective of evidence showing when TOCs costs and revenue losses increase substantially above formulaic Schedule 4 compensation.

[8] Source: Network Rail CRM Claims database – extract taken on 27 January 2017.

We consider that SPD is capturing a reasonable number of disruptive possessions, and observe that at least 5% of service groups have triggered SPD so far in CP5[9]. This is also consistent with the intent of SPD set out in the track access contract. We consider that the 5% figure is about right, considering that SPD should, in our view, only reflect the most disruptive possessions (c.1%). We note ORR's concerns over the contractual wording of SPD where the absolute revenue loss threshold over three billing periods is higher than that for seven periods.

b) Category 3 disruption

In ORR's "initial thinking on negotiated compensation arrangements for planned disruption", it notes that there are some issues with the current arrangements for Category 3 disruption for freight operators. However, ORR does not set out any options for this. We have provided a suggestion for improving this, below.

Under the current arrangements, if a freight operator believes that a Category 3 Disruption has occurred, it is entitled to claim for costs, direct losses and expenses ("Actual Costs") as a result of that Schedule 4 disruption. These claims can take between one and four months to resolve once freight operators have provided suitable evidence, and require an excessive amount of industry resource[10], given the scale of the issue.

At ORR's PR18 review of Schedules 4 and 8 workshop in August 2016, freight operators suggested that a 'proxy' Category 3 Disruption rate could be introduced, calibrated to cover Actual Costs. This rate could be used for the majority of Category 3 Disruptions, but if Actual Costs significantly exceeded this, freight operators could claim these from Network Rail (with appropriate evidence). We think that this idea could significantly reduce industry resource used in trying to agree Actual Costs compensation. However, we would like to explore the idea of introducing a threshold on freight operators initiating a claim, such that claims are only made when there is a significant difference between the costs incurred and those provided for by the proxy rate. It would also ensure that freight operators received compensation for the disruption they experience in a timely manner. We consider that this option should be explored further.

c) Incentives for amended timetables

In the event of extreme weather, it is very important that the industry provides passengers with as much certainty about the level of train service that will be available, with as much notice as possible. It will often be the case that only a reduced timetable will be possible when extreme weather occurs. In the absence of a realistic (reduced) timetable on these extreme weather days, passengers are likely to experience significant delays and suffer as a result of the industry attempting to deliver an unrealistic level of service.

We would welcome reconsideration of ORR's proposed de-prioritisation of the incentives for amending timetables for PR18, specifically in the case of extreme weather. Currently, if

[9] This figure is likely to be higher, as Network Rail has no visibility of train operators that have triggered SPD due to the "Cost Thresholds", since these are dependent on the actual costs that train operators have incurred.

[10] Each Category 3 claim typically requires 30-40 person hours from Network Rail, and presumably a similar amount from freight operators.

Network Rail enters an amended timetable for a day of extreme weather, it becomes liable for Schedule 4 compensation payments (and operators and Network Rail become liable for Schedule 8 payments for any further disruption on the day). These compensation payments are inconsistent with the evidence put forward in the Passenger Demand Forecasting Handbook (PDFH), which says that:

"*Some delays are caused by circumstances that passengers understand and hence these will probably not cause the scale of impact the values would forecast; examples include snow and flooding where other modes of transport can be even more adversely affected.*"

We recognise that there may be a few difficulties with defining an extreme weather day, but see merit in exploring this issue further so that more realistic timetables can be offered to passengers. We would, therefore, welcome the opportunity to work with industry and ORR in PR18 to explore options for taking this forward.

Question 18: Do you wish to submit relevant evidence regarding: a) processes associated with planning possessions; and/or b) planning alternative arrangements to deal with planed disruption (e.g. the notification that is needed to arrange bus replacement services)?

We have briefly discussed the processes associated with planning possessions with ORR previously, and would be happy to provide ORR with a Network Rail contact who can provide more detailed insight about our possessions planning processes.

We consider that operators are better-placed to provide evidence on planning alternative arrangements to deal with planned disruption.

Aligning Incentives

Question 19: Do you have any views on how financial incentives could be improved to encourage collaboration between Network Rail and operators to reduce industry costs?

Any financial incentive aimed at improving collaboration between Network Rail and operators to reduce industry costs needs to be **simple, understandable and easy to administer**. Based on industry discussions and our own experience in CP5, we consider that the route-level efficiency sharing (REBS) mechanism, in its current form, does not meet these criteria and is not driving the intended behaviours.

While we have concerns about the current design of REBS, we consider that its intention is sound. We agree that there is merit in a having a default mechanism in place to encourage collaborative working between operators and Network Rail.

We consider that the focus for PR18, therefore, should be on addressing the current issues with REBS (which we discuss below) and developing an improved sharing mechanism that is attractive to all parties. One of the key factors contributing to the success of an improved default sharing mechanism in CP6 should be that there is a reasonable expectation that Network Rail will outperform the relevant baselines. This could mean that customers may be more inclined to be part of the mechanism.

Industry incentive alignment

The importance of aligning incentives between Network Rail and operators was set out in the Secretary of State's December 2016 written statement to Parliament on rail reforms and the future of the railway in Great Britain. We strongly support this desire to align incentives, which is consistent with commitments made in our Transformation Plan.

Currently, there are various ways in which we can work with our customers to align behaviours through shared incentives and objectives, which include alliances. Different forms of alliance arrangement may be appropriate for different parts of the railway. For example, in May 2015 Network Rail and Abellio ScotRail entered into a bespoke 'deep alliance' arrangement. While remaining separate companies, both organisations are working to achieve common aims and objectives led by a common managing director and senior management team. Other types of alliance include 'framework alliances' which focus on more specific and mutually beneficial opportunities for Network Rail and its customers.

We recognise, however, that these arrangements may not always be practicable or possible. On this basis, we see merit in the continuation of a simple default efficiency benefit sharing mechanism in CP6, subject to a number of design improvements that we discuss, below.

REBS in CP6

PR18 provides the industry with an opportunity to consider changes to the mechanism, which can be informed by experiences to-date. We would welcome the opportunity to work with the industry and ORR to redesign the current mechanism so that it is considered as an attractive default option, when bespoke arrangements are not possible.

We note that ORR plans to consult on detailed REBS policy in mid-to late-2017. Prior to this consultation we think that there would be merit in ORR holding a workshop where operators and Network Rail can feed directly in to the policy development for an improved default sharing mechanism and assist in shaping ORR's PR18 proposals.

The remainder of our response to this question sets out our views on the various design improvements and options presented in ORR's consultation.

1. Removal of REBS

A key focus in CP5 and going forward, as set out in our Transformation Plan, is to align our targets with our customers' targets. We consider that a default sharing mechanism should form part of a suite of options for collaborative working which supports this objective. We consider that it would be more appropriate to review and improve the existing REBS mechanism, than remove it and replace with something different that does not build on the experiences to-date.

For REBS to be successful in CP6, it will be important that it is seen as a viable alternative for those parts of the railway where alliances are not possible. We consider that this will be contingent on the reform of REBS to address the issues with the current mechanism that have been experienced so far in CP5. It is important that the reforms have cross-industry support so that our customers see REBS as a real opportunity to work with Network Rail to deliver improvements to the network and share in the resulting benefits.

2. Changing REBS

Whilst REBS has only been operational since the start of CP5, there are clear areas where it could be improved in light of experience to date. We discuss these below.

a) Alignment of REBS baselines to Network Rail Business Plans

The REBS route baselines in CP5 for Scotland and the nine England and Wales routes[11] are not aligned to Network Rail's business plans.

When the REBS route baselines were set as part of Network Rail's CP5 Delivery Plan, we were constrained by the need to reconcile them with the Scotland and England and Wales totals in ORR's PR13 Final Determination for expenditure / income on a line-by-line and year-by-year basis. They were also fixed for the duration of the control period. This created a disconnect between route business plans and REBS route baselines.

We strongly consider that the lack of alignment between REBS route baselines and our route business plans (which are updated during the control period) has created unnecessary complexity and constrained the overall effectiveness of REBS.

A key improvement for CP6, therefore, would be to align the REBS route baselines with Network Rail's route business plans for CP6, and for it to work alongside the process for revising and updating route business plans during the control period. This approach would ensure that the REBS route baselines are aligned to what each route is planning to deliver, and would allow for performance against the REBS route baselines to be easily and transparently tracked.

There also needs to be sufficient flexibility in REBS to recognise that Network Rail's current eight routes are not static geographies and may be subject to change during CP6 and beyond. We will need to agree how to manage possible changes to Network Rail's route structure within REBS going forward.

While we consider that flexibility to update the REBS route baselines will be important to maintain alignment with route business plans during the control period, we are mindful of the additional risk that this could have on participating operators. Participating operators would have made their decision to opt in at the beginning of CP6 on the basis of the original set of REBS route baselines, which could then be subject to further change. Consideration would be required, therefore, on whether any further opt-out provisions would be needed during the control period, following any significant changes to the route baselines.

[11] London North Eastern (LNE) and East Midlands and Kent and Sussex now operate as two routes (LNE & East Midlands and London South East (LSE)) meaning that for operating purposes we now have eight rather than ten routes across the network.

b) Narrower scope based on route income and expenditure categories

We are concerned that the current scope of REBS may be too broad, including some elements of income and expenditure that could be beyond operators' reasonable influence. On this basis, we consider that the current REBS scope could be narrowed. At this stage, we have the following observations:

- **Route income and expenditure categories:** As part of devolution and route-based regulation, there is a greater focus on routes and delivering for our customers. This includes the development of route scorecards and route business plans that are aligned to the needs of our customers. We consider, therefore, that REBS should only include income or expenditure categories that are directly within the control of the routes. Central costs that have been allocated to routes should be excluded. Income and expenditure at a route level could be more easily influenced by operators, especially since they would have more oversight of the development of route business plans, which as above, we consider should be aligned to REBS baselines.

- **Income and expenditure categories that operators can influence:** There are areas that we consider operators could influence that should continue to be included in REBS (e.g. Schedule 4 and possession planning).There are also areas of Network Rail income and expenditure (e.g. property) currently included in REBS, over which we understand operators have limited influence. We believe that enhancements should continue to remain outside of the scope of REBS because it would otherwise expose train operators to too much risk. Additionally, we suggest that Schedule 8 could also remain outside the scope of REBS since it is an incentive regime in its own right. We consider that its removal would likely assist in the simplification of REBS.

As part of the consideration on the scope of REBS for CP6, there could be an option of a more fundamental reform to the structure of REBS. One option could be to allow operators to sign up to elements of REBS rather than in its totality. For example, operators could participate in a REBS mechanism focused on just operating, maintenance and total Schedule 4 expenditure (and associated income categories). A second REBS mechanism could be focused on renewals expenditure (and associated income categories). This could allow operators to have more choice within the overall mechanism by choosing a 'type' of REBS that includes the income and expenditure categories that they consider they are most able to influence. We consider that if this idea was progressed, there should only be two or three 'types' of REBS for operators to choose from. It would add significant cost and complexity to the regime if operators could select individual income and expenditure categories to design a bespoke REBS.

We would welcome further discussion on this suggestion with industry and ORR, in particular on whether it would be practicable and if so, what groups of income and expenditure would be appropriate.

c) Optionality

There has been limited operator participation in REBS in CP5. We consider that if improvements are made to REBS (some of which are discussed, above) and that there is a reasonable expectation of outperformance of the REBS baselines, then operators could be more inclined to opt-in to REBS in CP6. If REBS is not considered to be an attractive option for operators, we are concerned that making participation mandatory would be counter-productive and unlikely to encourage greater collaboration.

We also consider that there is a strong argument for optionality to remain for freight operators and open access operators due to the fragility of their business models.

d) Sharing percentages

Network Rail agrees that financial exposure offers the potential for train operators and freight operators to work more closely with Network Rail to reduce costs and inform route business plans. We believe that operators should be exposed to both upside and downside risk to ensure that the mechanism is fair to both parties and has a genuine incentive effect. The efficiency benefit sharing mechanism (EBSM) in CP4 provided operators with upside only financial exposure. We do not consider that it was effective in encouraging collaboration between Network Rail and its customers. It is important that we build on the experiences from CP4 and CP5 to improve REBS and we consider that an upside only mechanism would not be appropriate.

While we consider that the upside and downside sharing percentages of 25% and 10% respectively are reasonable, there could be merit in reviewing the current upside and downside payment caps. The way in which they are currently applied means that they 'bite' at relatively low levels of REBS over- and under-performance. This could go some way to addressing the industry concerns that ORR sets out in its consultation that the amount of financial exposure is not significant enough to drive a change in behaviour.

e) Basis of REBS

Network Rail does not support ORR's proposal to use the cost attribution project as a basis for the cost allocation in REBS. The purpose of the cost attribution project is to inform the allocation of Network Rail's fixed costs to operators. The cost allocation work is allocating our regulatory cost base, whereas REBS is based on outturn expenditure. Instead, we think it is important to use route income and expenditure categories which are managed and recorded at a route level as the basis for REBS.

Summary

The response to this question has considered a number of changes and considerations in respect of REBS for CP6. We look forward to developing these ideas further in discussions with industry and ORR over the coming months.

Question 20: Do you have any views on the cost categories you think could be controlled by operators and whether these costs would be suitable as the basis of a potential future mechanism?

We note that the question focuses on the cost categories that operators can **control**. We do not believe that operators can control Network Rail's cost categories and would therefore suggest that ORR focuses on the cost categories that operators can **influence**. In regards to the cost categories we believe that operators can influence, please refer to our response to Question 19, above, in particular part 2(b).

2. Comments on ORR's Supporting Documents

Comments on ORR's Impact Assessments

1. We welcome ORR's development of draft impact assessments on how changes to the charges and incentives regime will impact on stakeholders. In addition we agree that it is important that ORR's has committed to considering the cumulative financial impact of changes on operators in its working paper in early 2017.
2. The purpose of this section is to set out comments on ORR's impact assessments. Below we provide general comments on ORR's approach to its impact assessments, which we consider apply to all charges. In addition, we also provide comments on the individual assessments that ORR has carried out.
3. These comments on the impact assessments are in addition to the points we have raised in response to the consultation questions, above.
4. Where we support ORR's proposals within the consultation, we have not commented in detail on the accompanying impact assessment.

General comments on Impact Assessments

<u>Approach</u>

5. We consider the impact assessments should be 'living documents' and that ORR should continue to update them as the impacts of its proposals become clearer.
6. We suggest that ORR adopts a consistent approach to carrying out its impact assessments and includes the relevant objectives in this assessment.
7. We consider that ORR should also consistently assess each proposal against its general criteria, as it stated that it would do in its assessment framework document which was published alongside the consultation. We suggest that ORR sets out this assessment clearly in its impact assessment. We note that ORR does not do this in all of its impact assessments and we would encourage it to do so consistently, particularly because this is where potential implementation and data requirements issues should be identified.
8. We welcome ORR's use of tables to structure some of its impact assessments, which includes a summary table, with ticks and crosses describing how the proposal performs against the relevant outcomes and criteria. We think that this is an accessible way for readers to understand ORR's view in relation to how each option performs. We suggest that ORR includes these tables in all of its impact assessments, which is not the case, at present.
9. We consider that the impact assessments appear to focus more on the impact on train operators and do not assess the potential impact of changes on Network Rail in detail. We understand that it is important to assess the impact on train operators, particularly in scenarios where the impact of the change is likely to be much more significant on operators than Network Rail. We consider, however, that a brief assessment of the impact on Network Rail should also be included.
10. We consider that even where ORR is proposing to broadly retain the existing charging structure that it should still carry out an impact assessment, for example, the Variable Usage Charge (VUC). We consider that ORR proposes sufficient changes in its consultation in relation to the VUC to warrant an impact assessment. For example, ORR's view that new legislation means that it is not possible to phase in any increases in

relation to the VUC for CP6 (except where there are substantive methodological changes) represents a significant change in approach compared to PR13. This change could also potentially have a significant impact on the level of operators' charges in CP6. Similarly, we consider that the potential 'recalibration' style changes to the VUC that ORR notes in its consultation (e.g. reflecting maximum line-speeds in charges) should be considered as part of an impact assessment.

PR18: Fixed costs- Draft impact assessment on options for fixed costs

11. We are concerned that the impact assessment may be overpromising in relation to what this proposal, and our cost allocation work, is likely to deliver. It is not clear to us that fixed cost charges, or the cost allocation work, will result in material changes in the following areas:

- Our ability to make efficiency savings. As set out in ORR's impact assessment, we already face a strong financial incentive to outperform its efficiency assumptions.

- ORR's ability to benchmark our fixed costs across the network. Particularly, as the cost allocation work will produce an improved **allocation** of our **regulatory cost base**. It will not result in more granular information in relation to the distribution of **outturn expenditure**.

- Network Rail's capacity allocation decisions which are understandably driven by administrative mechanisms. However, the cost allocation work could potentially inform funders' future decisions in relation to the specification of services.

- Open access operators scrutinising our fixed costs. In principle we agree that exposing open access operators to fixed cost charges should encourage greater scrutiny. However, in reality, scrutiny may be limited by operators' engineering expertise in relation to infrastructure costs. In addition, operators' scrutiny may focus on the market can bear test, particularly if this test is likely to act as a cap on their fixed cost charges. Methodological changes (e.g. in relation to how costs are allocated to operators) can also dominate discussions at periodic reviews, and often have a more significant effect on operators than potential efficiency savings.

- Revisiting the REBS mechanism. Particularly, as noted above, the cost allocation work is **allocating** our **regulatory cost base**, and REBS is based on **outturn expenditure.** We discuss this in further detail in our response to Question 19 of ORR's consultation.

PR18: Freight mark-up charges – Draft impact assessment on simplification option and methodological change

12. We have no additional comments on this impact assessment. Our views on the proposals for the freight mark-up charges have been captured in our response to Questions 2 and 3 and in our general comments on the impact assessments.

PR18: Station long term charge (LTC) – Draft impact assessment on the methodology at managed stations

13. We recognise the need for an impact assessment regarding improvements to the LTC cost forecasting methodology.
14. As ORR states, it is not possible to quantify the impact of the improved cost forecasting methodology at this stage. However, as the work progresses, the impact assessment will no doubt become more informative.
15. We welcome ORR's support for this piece of work.
16. As ORR writes, we will ensure that stakeholders are kept informed as this modelling work progresses and the impact of the improved methodology becomes clearer.

PR18: Qualifying expenditure (QX) – Draft impact assessment on QX transparency

17. Overall, the impact assessment is well-balanced. We agree with the comments regarding the potential benefits of QX transparency (the potential for more efficient operating costs) but also, like ORR, recognise the need to provide additional context for any QX numbers in order to ensure that the figures are not misleading.
18. Understandably, the impact assessment cannot provide any quantitative assessment of the impact of QX transparency. ORR does not have information on current QX charges or efficient operating costs.
19. The impact assessment states: "Network Rail is in the process of publishing total QX charges at managed stations on the Network Rail website. This is scheduled to be completed before the end of 2016". This has not proved possible. We will publish this information, alongside suitable contextual information, in due course.
20. Alongside the figures on total QX at each managed station, we hope to publish:

    - A guide which explains QX and why QX charges differ between stations; and

    - A set of case studies which provide detailed information on QX charges at a handful of managed stations.

PR18: Capacity charge – Draft impact assessment on options for the capacity charge

21. We have responded to ORR's impact assessment for the Capacity Charge within our question responses as ORR has asked for specific comments in relation to each option under consideration. Please see our response to Questions 8 and 9.

PR18: Coal spillage charge – Draft impact assessment on abolishing the charge

22. We consider that abolishing the coal spillage charge (CSC) would reduce the administrative burden on the whole industry, including Network Rail and ORR, rather than just freight operators.

PR18: Schedule 8 – Draft impact assessment on Schedule 8 and passenger compensation

23. We have no additional comments on this impact assessment. Our views on passenger compensation have been captured in our response to Question 13.

PR18: Schedule 8 – Draft impact assessment on approach to setting benchmarks

24. Network Rail is concerned that ORR did not use this impact assessment to discuss the different options for setting operator benchmarks in the passenger regime. The lack of clarity on the potential options makes it difficult for Network Rail to respond to this point in the consultation.
25. We consider that the benchmarks should be set at realistic and achievable levels of performance for both operators and Network Rail to minimise money flows in the regime.
26. It would be useful for ORR to clarify whether basing benchmarks on past performance improves or limits the overall incentive effects to improve performance. ORR presented differing views on this approach to setting freight and train operator benchmarks within the consultation and accompanying impact assessment.
27. ORR has stated that setting passenger operator benchmarks and Network Rail's benchmark in the freight regime based on past performance reduces the incentive to outperform the benchmark, since in doing so could result in a more challenging benchmark in the subsequent control period. Whilst we note that this may be an issue, we consider that there is still an incentive to out-perform the Schedule 8 benchmarks during the control period, as the respective party would receive a payment through the star model.
28. ORR stated that improved performance at the end of the control period would act as a disincentive to operators and Network Rail (in the freight regime) as it would result in a more challenging benchmark for the following control period. We note that the recalibration period used for past performance has previously been in the middle of the previous control period, so performance at the end of the control period would not impact the benchmarks of the upcoming control period.
29. ORR has not assessed its proposal to continue to set freight operator benchmarks based on average historical performance. Whilst we support this proposal, we consider that the reasoning behind this decision could have been discussed in the impact assessment.
30. We consider that ORR could have used this impact assessment to discuss the benefits of aligning Network Rail's freight benchmarks to Network Rail's freight performance measure.
31. As discussed in our response to ORR's consultation, it is important that ORR concludes in a timely manner on policy areas that affect the recalibration of the regime, such as benchmarks, so as not to delay the process.

PR18: Schedule 8 – Draft impact assessment on the measure of passenger operator performance

32. Whilst PEARS cannot currently calculate Schedule 8 payments for a TOC-on-TOC regime, we would not consider that this is why the regime is currently based on TOC-on-Self. We understand that a move to a TOC-on-TOC regime has not been discussed since before 2006. It may have been possible to update PEARS for this, if it was required in the intervening periodic reviews.
33. We do not agree that Network Rail's incentives will be reduced by a move to a TOC-on-TOC regime. Network Rail is targeted based on industry performance measures, and could face punitive measures if these are not achieved. This acts as a very strong incentive on Network Rail to improve whole-industry performance.

34. To clarify, we would only need to update PEARS and not Network Rail's billing system (TABS).

PR18: Schedule 8 – Draft impact assessment on effectiveness of the SPP regime

35. ORR has stated that the sustained poor performance (SPP) mechanism acts as an incentive for Network Rail. We consider that SPP has limited incentive effects for two key reasons:

- Network Rail cannot forecast likely SPP costs.
- As the current threshold is so readily triggered, most train operators will be in SPP at some point in the control period even when performance is near to targeted / benchmark levels.

36. ORR notes that there have been no SPP claims in CP5, potentially because train operators have been deterred by the resource intensive process of making a claim. We consider there to be other reasons why an operator may not claim whilst in SPP, for example, the formulaic Schedule 8 compensation may be sufficient to cover their revenue losses, even when train operators are in SPP. Also, SPP may be too easily triggered at performance levels that are not that different to target / benchmark levels and do not cause significant changes in train operators' costs/revenues.
37. In ORR's assessment of the options, we consider that a few key points have been missed:

- There is a higher potential for SPP claims to be made for the cost based claims option. While each claim should be less resource intensive, the increased number will have an impact on industry resource.
- An increasing number of claims could result in an increased flow of money from Network Rail to TOCs. This may mean that Network Rail has to forego other commitments to pay for this.

Comments on ORR's initial thinking and proposals

38. The purpose of this section is to set out comments on ORR's initial thinking and proposals.

PR18: Schedule 4 – Proposal not to pursue a range of schedule 4 issues in PR18

39. We have no additional comments on this supporting document.

PR18: Schedule 4 – Initial thinking on incentives created by notification discount factors

40. ORR has stated in its supporting document that "if a particular notification discount factor (NDF) is, for example, 60%, Network Rail pays 40% of marginal revenue effect (MRE)". We consider this to be incorrect. If an NDF is 60%, Network Rail pays 60% of MRE, as set out in the table that ORR provided in the impact assessment.

PR18: Schedule 4 – Initial thinking on the approach to calculating the access charge supplement

41. We have no additional comments on this supporting document. Our views on the approach to calculating the access charge supplement have been captured in our response to Question 17.

PR18: Schedule 4 – Initial thinking on negotiated compensation arrangements for planned disruption

42. We note that few responses to ORR's November 2015 stakeholder letter stated that the trigger was too high. Therefore we are unsure as to why ORR considers this as one of the two main issues that stakeholders raised in response to the letter.
43. We support ORR's suggestion to review the contractual wording and process for sustained planned disruption (SPD) with a view to making the process less cumbersome and protracted. It is important that this update ensures that TOCs provide sufficient evidence to claim for SPD and Network Rail is given sufficient time to examine the evidence.
44. As with SPP, we consider SPD to have no incentive effect as we cannot forecast compensation to operators in advance. We therefore do not think that reviewing some or all of the thresholds for triggering bespoke compensation would improve the accuracy of the incentive on Network Rail with respect to particularly long/large possessions.
45. Network Rail would like to discuss with ORR the evidence provided by TOCs for a change in the SPD threshold.