

**Periodic Review 2013  
Consultation on Schedules 4 and 8 –  
Network Rail's response**

28 January 2013



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## EXECUTIVE SUMMARY

Schedules 4 and 8 of the track access agreements between Network Rail and train operators set out the arrangements for compensation for planned and unplanned disruption, respectively. As demonstrated by recent research by Steer Davies Gleave, they help uphold the value of passenger railway franchises, thereby reducing pressures on the public purse, and provide a more certain environment for passenger and freight operators. They also have important incentive qualities. Schedule 4 encourages Network Rail to plan 'possessions' that are efficient and effective. Schedule 8 incentivises Network Rail to avoid unnecessary or excessive unplanned disruption, for example as a result of the weather or infrastructure problems. It also encourages train operators to avoid delay caused by them. Schedules 4 and 8 also provide the industry with important 'price signals' about the 'value' of mitigating disruption, helping the industry make decisions that are in the best interests of passengers and freight customers.

### *Getting Schedule 8 benchmarks 'right'*

Schedule 8 is a 'benchmarked' regime, meaning that payments are based on performance relative to pre-defined local baselines. In the past, the levels of benchmarks have been informed by Network Rail's regulatory performance target. Network Rail's Strategic Business Plan (SBP) for CP5 contains a detailed Performance Plan for England, Wales and Scotland. The Performance Plan is set against the backdrop of a scale of enhancements which is unprecedented in the modern era, extensive refranchising, and significant projected traffic growth in CP5. The SBP proposes a range of performance of 91 to 93 percent PPM, and includes a plan to deliver PPM of 92.5 percent by the end of CP5, which is in line with the High Level Output Specifications (HLOSs).

It is important that Schedule 8 benchmarks in CP5 are fair and transparent, provide for an appropriate balance of risk among industry parties and offer the right incentives. We will be seeking to engage with ORR and the industry shortly around the principles for setting Schedule 8 benchmarks for CP5.

### *Getting Schedule 8 payment rates 'right'*

Besides benchmarks, the other key parameters of the Schedule 8 regime are payment rates, which govern the amount of compensation paid by industry parties when they cause lateness. Schedule 8 payment rates also determine payments under Schedule 4 and the level of the capacity charge. In December 2012, Network Rail held a workshop aimed at demonstrating the importance of getting payment rates 'right', so that operators receive full compensation for lost revenue as a result of disruption beyond their control. Payment rates that are either too low or too high will lead to increased volatility in industry financial flows. Moreover, setting payment rates that are not an accurate reflection of financial impacts could encourage perverse behaviour, and introduce reputational risk to the industry.

At the workshop there was widespread recognition that increased Schedule 8 payment rates would result in larger monetary transfers from train operators to Network Rail if Network Rail outperforms against benchmarks, and larger monetary transfers from Network Rail to TOCs if Network Rail underperforms against benchmarks. It was agreed that the industry should engage closely with the recalibration of Schedule 8 payment rates to ensure that they accurately reflect local revenue effects in CP5.

## EXECUTIVE SUMMARY

### *Encouraging collaboration*

In a related vein, ORR had asked in earlier consultations whether Schedule 4 and 8 payment rates should be set below 100% of full compensation. The idea was that doing so may encourage operators to engage more closely with Network Rail in relation to possessions planning and performance. In the current consultation, ORR advises that it proposes to keep payment rates at 100% compensation levels. For the reasons described above, we support this position.

However, we believe strongly that there are other policies that ORR could pursue which will encourage greater collaboration. We note that ORR states that “it is currently proposed that Schedule 4 and 8 payments are included within the REBS mechanism”. We welcome this statement. We consider that the inclusion of Schedules 4 and 8 inside the Route-based Efficiency Benefit Sharing (REBS) regime is essential for the effectiveness of REBS and the continued efficacy of the Schedule 4 and 8 regimes themselves. Moreover, alliancing and bespoke arrangements are becoming increasingly commonplace, and delivering real benefits in terms of efficiency, performance and possessions planning. ORR should continue to support the industry in relation to alliancing and bespoke arrangements around Schedules 4 and 8 in particular.

### *Sustained poor performance*

A core feature of the Schedule 8 regime is the provision of compensation for ‘Sustained Poor Performance’ (SPP), which allows operators to claim compensation beyond the level provided by the formulaic Schedule 8 regime. We believe that it is appropriate that train operators should be protected from the financial impacts of prolonged periods of poor performance, and fully support the principle of the SPP mechanism. Like ORR, however, we recognise the importance of ensuring that the SPP arrangements are not triggered by short-term fluctuations.

We fully support the proposal to increase the SPP ‘threshold’, from its current level whereby performance must be 10% worse than benchmark for TOCs to claim. To inform the appropriate, evidence-based choice of SPP threshold for CP5, we have commissioned independent consultants Steer Davies Gleave. Steer Davies Gleave’s recommendation is that the threshold be raised to 30% since:

- At this level, the risk to TOCs of suffering losses significantly in excess of the standard Schedule 8 compensation is small;
- Below this level, there is a risk that the standard Schedule 8 regime would be undermined, with Network Rail facing a significant number of claims in instances where it is performing at benchmark levels in aggregate; and
- The level is broadly consistent, in terms of the performance levels at which SPP would be triggered, with previous threshold levels at the end of CP3.

### *Minimising transactions costs*

The central strength of the Schedule 4 and 8 regimes is that they save industry resources and avoid unnecessary conflict by providing appropriate compensation on an ‘automatic’ basis through the contractual formulae, albeit with some ‘swings and roundabouts’ in specific circumstances. We consider that this feature should continue to be protected. For example, ORR has proposed that passenger train operators should be permitted to claim cost compensation from Network Rail when it cancels a ‘Type 1’ possession and services are then reinstated. We fully support this principle, but consider that this is most appropriately dealt with by means a ‘liquidated sums’ approach.

# 1. INTRODUCTION

## 1.1. Background

In May 2011, ORR published its first Periodic Review 2013 consultation, which raised various issues in relation to Schedules 4 and 8<sup>1</sup>. We submitted a response to that consultation in September 2011<sup>2</sup>. ORR's second consultation was published in December 2011, with a focus on incentives<sup>3</sup>. Within these consultations, several key issues were addressed around Schedules 4 and 8.

This document contains Network Rail's response to ORR's consultation on Schedules 4 and 8, issued in November 2012<sup>4</sup>.

## 1.2. Structure of this document

ORR structured its consultation around the following headings:

- Issues relating to Schedules 4 and 8;
- Schedule 4 passenger possessions regime;
- Schedule 4 freight possessions regime;
- Schedule 8 passenger performance regime;
- Schedule 8 freight performance regime; and
- Compensation related to charter operators.

ORR asked stakeholders to respond to a set of specific questions relating to each of these topics.

The following chapters are structured along the same lines as ORR's consultation and provide our responses to ORR's questions.

ORR held a workshop on 16 January 2013 for stakeholders to help develop thinking on the proposals discussed in the consultation. Network Rail engaged actively in that forum, and the views set out in this document reflect the statements made on the day.

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<sup>1</sup> Periodic Review 2013 first consultation, 25 May 2011. Available at: <http://www.rail-reg.gov.uk/pr13/PDF/PR13-first-consultation-document.pdf>.

<sup>2</sup> Periodic Review 2013 first consultation – Network Rail's response, 2 September 2011. Available at: <http://www.rail-reg.gov.uk/pr13/PDF/pr13-first-consultation-nr-20110902.pdf>.

<sup>3</sup> Periodic Review 2013 consultation on incentives, 14 December 2011. Available at: <http://www.rail-reg.gov.uk/pr13/PDF/pr13-first-consultation-nr-20110902.pdf>.

<sup>4</sup> Consultation on Schedules 4 & 8 possessions and performance regimes. Available at: <http://www.rail-reg.gov.uk/pr13/consultations/possessions-and-performance-regimes.php>

## 2. BACKGROUND AND CONTEXT

### 2.1. ORR's position

In its consultation on Schedules 4 and 8, ORR summarised its position in relation to the following areas.

- ORR stated that transparency has a vital role in achieving greater industry efficiency and customer focus.
- ORR noted that there may be scope to improve the transparency of possessions management, ensuring that those affected by planned service disruption are adequately consulted.
- ORR believed there would be merit in requiring Network Rail to consult with passengers and the customers of freight operators in planning possessions.

### 2.2. Network Rail's current position

#### Responses to consultation questions

Q1

What are your views on whether or not passengers and freight customers are adequately consulted on the planning of possessions? What activity currently takes place?

The possessions planning process is highly consultative. Formal processes are in place through which Network Rail engages with train operating companies (TOCs) and freight operating companies (FOCs). A primary purpose of this consultation process is to understand the needs of both passengers and the customers of freight operators, and design possessions plans accordingly.

The planning process is governed by Part D of the Network Code. Each year, Network Rail publishes an Engineering Access Statement (EAS) which describes the rules regulating the arrangements for engineering access to the rail network. It sets out the location, number, dates and duration of possession access which are required to deliver inspection, maintenance, renewal and enhancement activities.

The contents of the EAS are determined by Network Rail through a mixture of informal and formal consultation with train operators, with the aim of achieving the optimal balance between access to the network for train operations, benefitting passengers and freight customers, and access for inspection, maintenance, renewal and enhancement work. This leads to the publication by Network Rail of the Final Engineering Access Statement. Train operators have a right of appeal against the contents of the Final Engineering Access Statement.

The EAS is supplemented by four-weekly Period Possession Plans (PPPs). A detailed programme of proposed engineering works is issued as the Draft PPP at least 28 weeks before the start of the 4 weeks concerned. This contains details of proposed disruptive possessions, together with any non-disruptive possessions. The Confirmed PPP is issued 26 weeks prior to the start of the relevant 4 weekly period, giving sufficient details of planned disruptive possessions to enable an assessment of train alterations to be made.

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In certain instances, prior to the conclusion of consultations, Network Rail often arranges a 'Trains Meeting' for all affected operators. It is at this stage where a particular possession, or series of possessions, will often result in significant train alterations. Network Rail regularly consults train operators outside of this process if there are any particular areas of concern.

Q2

What are your views on whether we should encourage Network Rail to consult with passengers and freight customers in the planning of its possessions?

Our experience has been that TOCs and FOCs represent the interests of their customers in an articulate and effective manner. In addition, operators understand the operational constraints associated with running a complex railway network. We therefore consider that the current possessions planning process gives rise to appropriate outcomes, hitting the right balance between protecting the interests of railway users and allowing suitable access to the network that allows works to be carried out efficiently. Not only does the current process give rise to good results, it is also streamlined, and conflicts are rare.

The results of the current consultation will be helpful in determining whether there is an appetite among passengers and freight customers to engage more closely in the possessions planning process.

If appropriate, and following the results of this consultation, we would welcome the opportunity to discuss with ORR, passenger and freight operators, together with their customers, whether and how Network Rail should consult with passengers and freight customers through the possessions planning process.

We consider that the following issues will be relevant in deciding whether and how passengers and freight customers should be consulted in relation to possessions planning:

- The benefits associated with engaging directly with passengers and freight customers;
- The trade-off between minimising whole-industry, whole-lifecycle costs and the shorter term interests of some end-users;
- Whether wider engagement could slow down the possessions planning process or make it less efficient; and
- Whether wider engagement could give rise to conflict between different parties and how this should be resolved.

Q3

If we were to encourage Network Rail to consult with passengers and freight customers in the planning of its possessions, do you have any suggestions on how we might go about doing this, for example, how such an obligation would be phrased and monitored?

We recognise the possible benefits associated with engaging with passengers and freight customers in relation to possessions planning. However, we would strongly oppose the introduction of additional regulatory requirements on Network Rail in this regard. Not only could such an approach make the possessions planning

## 2. BACKGROUND AND CONTEXT

process more costly and complex, we believe that it would be contrary to the interests of passengers and freight customers.

In particular, a regulatory requirement is unlikely to be sufficiently flexible to take account of the wide-ranging and changing needs of passengers and freight customers. Moreover, it is liable to turn any process of engagement into a 'box-ticking' exercise, rather than one which has the interests of passengers and freight customers at its heart. Similarly, such a process could encourage concentration on 'measures' defined by ORR, rather than on the outcomes desired by passengers and freight customers.

Rather, and as noted above, following the results of this consultation, we would welcome the opportunity to discuss with ORR, passenger and freight operators, together with their customers, whether and how Network Rail should consult with passengers and freight customers through the possessions planning process.



## 3. ISSUES RELATING TO SCHEDULES 4 AND 8

### 3.1. ORR's position

In its consultation on Schedules 4 and 8, ORR summarised its position in relation to the following areas.

*Whether to set payment rates to below 100% of the financial impact to train operators of planned and unplanned service disruption*

- ORR is minded to set Schedule 4 and 8 payment rates so that they compensate train operators for the full financial impact of service disruption caused by Network Rail and operators, as is currently the case. This view reflects the findings of the research by Steer Davies Gleave and subsequent evaluations of the advantages and disadvantages of the available options. In brief, Steer Davies Gleave found that:
  1. If Schedule 4 and 8 payment rates were reduced to 75% of full compensation, the total financial cost could be in the region of £45 million over a control period.
  2. The reduction to 75% of full compensation would not lead to a significant change in behaviour by Network Rail or train operators, due to the dominance of other, stronger incentives.

*The contractual provisions for dealing with extreme disruption due to external factors*

- ORR is minded to not introduce the Joint Restrictions of Use concept into Schedule 4 due to concerns that it could result in unintended consequences where the current contractual wording is not causing problems.
- ORR is of the view that it may be more effective for Network Rail and train operators to propose bespoke arrangements if there are particular localised circumstances where the current contractual wording does not work well.

### 3.2. Summary of Network Rail's previous response

*Whether to set payment rates to below 100% of the financial impact to train operators of planned and unplanned service disruption*

- In previous responses we have welcomed any recognition that not reflecting full costs could form part of a bespoke deal. However, we considered that, in the template regime, Schedule 4 and 8 payment rates should accurately reflect the full impact of performance on revenue. The reasons for this include the potential effect, if payment rates were reduced, on operators' risk and on franchise values, and the incentive that would be created for operators not to agree to necessary possessions.
- We also noted that ORR views the Schedule 4 and 8 regimes primarily as *compensation* mechanisms<sup>5</sup> whilst recognising that they also have incentive effects. We support this view. A general move away from the current approach would undermine ORR's stated rationale for the regimes.

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<sup>5</sup> ORR, Periodic Review 2013 consultation on incentives, Box 5.1

### 3. ISSUES RELATING TO SCHEDULES 4 AND 8

- An alternative would be to include Schedule 4 and 8 payments in the definition of Route-based Efficiency Benefit Sharing (REBS) mechanism. This would encourage train operators to work with Network Rail to help us improve performance and reduce the number and impact of possessions, whilst not undermining the rationales of the regimes. Moreover, this approach would not impact substantially on the risk faced by operators and Network Rail, since the effects would be contained within the REBS mechanism, with its *de minimis* thresholds and caps on payments.
- We considered that the incentives currently in place to ensure that we take into consideration the impact of service disruption on passengers are sufficient (including Schedules 4 and 8, our regulatory targets, Joint Performance Improvement Plans (JPIPs), reputational incentives, and management incentives). The history of performance improvement since the societal rate was removed (in 2004) supports this view.
- Network Rail welcomed ORR's indication that it is minded to approve bespoke agreements in certain cases. Whilst the detail should be left to individual discussions, proposals for any modified regimes will need to be backed up by evidence that there will be no adverse impacts on other operators, either operationally or commercially.
- We agreed that, given ORR's approval role, its Criteria and Procedures could usefully set out fundamental principles that ORR would expect the parties to have considered. This could be an effective way of preparing for the possibility of bespoke regimes, without actually dictating what a bespoke regime might look like.

#### *The contractual provisions for dealing with extreme disruption due to external factors*

- We welcomed ORR's recognition that it is important that parties are not perversely incentivised against 'doing the right thing', particularly around running a realistic timetable during extreme weather conditions.

### **3.3. Network Rail's current position**

#### **Responses to consultation questions**

Q4

Do you agree with the SDG research findings and conclusions on whether to set Schedule 4 and 8 payment rates so they do not compensate train operators in full for the impact of service disruption due to Network Rail and other train operators? If not, please tell us why?

We agree with the Steer Davies Gleave research findings and the conclusion that Schedules 4 and 8 function adequately as a compensation mechanism, and any change in the rates would be detrimental to their functionality.

We recognise Steer Davies Gleave's findings that reducing payment rates below 100% would not have a significant impact on operators' incentives to further engage with Network Rail, and our own discussions with train operators confirm this view.

### 3. ISSUES RELATING TO SCHEDULES 4 AND 8

Q5

Do you agree that we should continue to set Schedule 4 and 8 payment rates so that they compensate train operators for the full financial impact of service disruption due to Network Rail and other operators, where we do so currently? If not, please tell us why?

We agree that Schedule 4 and 8 payment rates should be set so that they compensate train operators for the full financial impact of service disruption due to Network Rail and other operators.

#### *Incentive effects*

We understand that the primary impetus behind ORR's rationale in considering whether to reduce compensation below full levels was to gauge whether doing so would encourage train operators to work more closely with Network Rail in relation to performance and possession planning. In light of Steer Davies Gleave's findings that a move to lower rates would not affect behaviour, we see no case in favour of setting rates below 100% (and as we note below, there are a number of disadvantages associated with reducing rates below full compensation levels).

We also note that train operators engage cogently and constructively with Network Rail in relation to performance and possessions under existing arrangements, for example through the JPIP process and the possessions planning arrangements described in the last chapter.

The JPIP process aims to improve collaboration between Network Rail and operators to make performance improvement easier and therefore deliver better overall performance than would otherwise be possible. A key aspect of the process is the movement away from a relationship based on the strict customer-supplier guidelines, towards one with increased openness and cooperation.

There are many benefits associated with the JPIP process. It allows for the creation of an industry plan by TOC, which focuses on output for passengers and encourages better collaboration between Network Rail and operators to work towards the most efficient and beneficial improvement projects. Examples of such benefits are numerous. A normal network collection of plans has previously resulted in an annual saving of approximately 1,000,000 delay minutes, and other, related PPM improvements.

Whilst cooperation in relation to performance and possessions is already strong, we recognise that it may be possible to go even further to align industry incentives. We consider that the most fruitful way forward in this regard will be through alliancing and bespoke arrangements, and we note that such agreements have already demonstrated a number of benefits. We believe that the REBS mechanism will also assist in further aligning the interests of train operators and Network Rail in relation to performance and possessions. This is discussed in detail, below.

#### *Encouraging conflict*

Not only does the evidence suggest that reducing rates below full levels is unlikely to result in operators engaging with Network Rail more strongly, we consider that reducing rates to below 100% could actually have the opposite effect by discouraging cooperation between operators and Network Rail. In particular, we are concerned that setting compensation payments below 100% of the full financial impact could lead to an incentive for operators not to agree to necessary

### 3. ISSUES RELATING TO SCHEDULES 4 AND 8

possessions as they would be penalised financially. This would be a suboptimal outcome, and could create conflict which could undermine the industry's continued efforts to work more effectively together.

#### *Schedule 4 and 8 as compensation regimes*

ORR states that the primary purpose of Schedules 4 and 8 is that the regimes provide compensation to train operators in instances of planned and unplanned disruption. In so doing, they reduce operator risk and protect franchise values, thereby reducing the overall cost of the railway industry. We support the view that the principal purpose of Schedules 4 and 8 is to provide compensation, although we agree with ORR that they also have important incentive properties.

In our response to ORR's PR13 consultation on incentives<sup>6</sup>, we stated that a compensation rate which did not fully cover the financial impact of disruption could impact on the financial risks associated with rail franchises, and could result in diminished franchise values. Steer Davies Gleave's research has confirmed this view. We therefore consider that a movement away from setting full compensation would undermine the primary role of Schedules 4 and 8 as defined by ORR, and could place an undue financial burden on taxpayers and passengers.

#### *Undermining the 'liquidated sums' regime*

Steer Davies Gleave also found that, if rates were to be reduced below 100% of compensation levels, operators may be more likely to use Sustained Poor Performance (SPP) and Sustained Planned Disruption (SPD) mechanisms in order to source the full level of compensation. We consider that this would be a very harmful outcome. In particular, this would undermine the liquidated sums nature of the regimes, potentially resulting in large transactions costs and an unnecessary administrative burden to the industry. Moreover, this could impose significant financial risk on Network Rail and, given the asymmetric nature of the SPP and SPD regimes, potentially lead to an increased funding requirement for Network Rail.

Q6

Are you of the view that there are other steps we could take to encourage train operators to have a stronger influence on the behaviours of Network Rail, in addition to those we are doing already? If not, please tell us why?

The industry, with support from ORR, has taken significant steps in recent years to encourage train operators to have a stronger influence over Network Rail's behaviours. The work of the Rail Delivery Group (RDG) is a prominent example. In addition, devolution by Network Rail has put decision-making within the company much closer to its customers, and has resulted in a step-change in our customers' ability and propensity to influence decisions locally. Alliancing and bespoke arrangements are becoming increasingly commonplace, and delivering real benefits in terms of efficiency, performance and possessions planning. Instances where alliancing has delivered real benefits are numerous, for example:

- The co-locating of Network Rail's and operators' performance teams increases the quality of performance data available, providing a more complete picture of the railway.

<sup>6</sup> Available on our PR13 webpage <http://www.networkrail.co.uk/publications/delivery-plans/control-period-5/periodic-review-2013/orr-publications-on-PR13/>

### 3. ISSUES RELATING TO SCHEDULES 4 AND 8

- A number of alliances are looking into fitting equipment to operator rolling stock in order to monitor the infrastructure condition. This not only identifies future faults, but is also used for seasonal treatment of the lines. Fitting equipment to operator rolling stock reduces the requirement to run the new Network Rail measurement train and increases the frequency in which track is checked, without the need to take a possession.

We consider that ORR should continue to support the industry in relation to alliancing.

#### *Schedules 4 and 8 and the REBS regime*

A key issue which remains outstanding in PR13, and which will be instrumental to continued and enhanced cooperation between train operators and Network Rail in CP5, is the inclusion of Schedules 4 and 8 within the Route-based Efficiency Benefit Sharing (REBS) regime. We note that paragraph 2.11 of ORR's consultation states that "*it is currently proposed that Schedule 4 and 8 payments are included within the REBS mechanism*". We welcome this statement from ORR.

We consider that the inclusion of Schedules 4 and 8 within the REBS regime will strengthen operators' incentives to engage with Network Rail both in terms of performance and possessions planning. The inclusion of Schedules 4 and 8 within REBS will reward train operators when Network Rail delivers above benchmark performance and efficient possessions.

It should also be emphasised that, by incorporating Schedules 4 and 8 within REBS, operators would be exposed to the performance-efficiency trade-off faced by Network Rail. In economic terms, both the costs and benefits of operators' actions to influence Network Rail would be captured through the REBS mechanism, resulting in the correct incentives for delivering optimal economic outcomes.

Equally importantly, we consider that the exclusion of Schedules 4 and 8 from REBS could create significant perversities, and undermine the credibility of the REBS regime, as well as Schedules 4 and 8 themselves. In particular, operators would be sheltered from poor performance and possessions through Schedules 4 and 8, but would benefit from increased efficiency through REBS. This could create perverse incentives. For example it could result in situations in which operators would encourage Network Rail to reduce costs at the expense of performance in order to benefit through REBS whilst being held neutral to the effects of performance by Schedules 4 and 8.

#### *Further measures*

In light of the measures described above – RDG's work, devolution, alliancing and REBS for example – we do not consider that further regulatory intervention to encourage operators to influence Network Rail's behaviour is either necessary or desirable. It is widely recognised that many of these initiatives are already delivering results. Whilst we recognise that we have further to go before the full benefits of these efforts are to be realised, we consider that any further regulatory measures could distract from the demonstrable benefits of these ongoing activities, and could undermine collective efforts to deliver performance, efficiency and other outputs.

### 3. ISSUES RELATING TO SCHEDULES 4 AND 8

Q7

Do you agree with our proposal not to introduce the Joint Restrictions of Use concept into Schedule 4 of template track access contracts? If not, please tell us why?

Having considered this matter further, we support ORR's proposal not to introduce a Joint Restriction of Use concept into Schedule 4 of the template track access contract. We note that recent alliancing activities have gone a long way towards addressing any problems that may have existed previously, and believe that bespoke arrangements should continue to be used to address difficulties as they arise locally.

Q8

To what extent (if at all) do you think the current contractual wording of Schedules 4 and 8 is acting as a barrier to Network Rail and train operators minimising disruption to passengers and freight customers during extreme disruption, e.g. during severe weather. If you are of the view that it does act as a barrier, we welcome any specific proposals on how it can be improved.

In general terms, we do not consider that the current contractual wording is acting as a barrier towards minimising disruption to passengers and freight customers. However, we recognise that local circumstances may mean that alternative contractual wording may be appropriate in some circumstances. We would encourage ORR to look favourably on joint proposals from train operators and Network Rail to make adjustments to the default Schedules 4 and 8 regimes where local circumstances are better suited to bespoke arrangements.

#### **3.4. Other remarks**

##### *Indexation of payment rates for inflation*

We note that ORR has recently confirmed in its financial issues decision document that the approach toward inflation will remain the same as in CP4. We welcome this decision by ORR. We expect that Schedule 4 and 8 payment rates will be uplifted in the same way in CP5.

## 4. SCHEDULE 4 PASSENGER POSSESSIONS REGIME

### 4.1. ORR's position

In its consultation on Schedules 4 and 8, ORR summarised its position in relation to the following areas.

#### *Methodology for disaggregating the Access Charge Supplement (ACS)*

- ORR is minded to adopt Network Rail's revised Route based Schedule 4 costs estimation methodology. Greater accuracy in the way Network Rail calculates the ACS would provide greater transparency, leading to franchised operators being better able to challenge Network Rail's Schedule 4 costs. Also, this would allow Network Rail to estimate Schedule 4 costs at Route level, which will help achieve better alignment between Schedule 4 costs and the ACS paid within each Route. Other potential solutions to this issue involve no change from how the ACS was calculated and allocated in PR08 and so do not address concerns raised by franchised passenger operators.

#### *Replacement bus cost compensation*

- ORR considers that it is important that the level of compensation received by train operators reflects the actual cost of bus provision they face, and does not lead to perverse incentives to run buses when the option to run a revised train service exists.
- ORR is minded to revise estimated bus mile compensation rates based on actual amounts paid during CP4. This will most likely be based on the actual cost of replacement buses in 2010/11 and 2011/12 to be consistent with the recalibration period for Schedule 8 payment rates. Currently, survey results show that the bus cost formula does not align with the actual cost of providing replacement buses.

#### *Replacement bus revenue loss compensation*

- ORR is minded to continue with the current system for calculating revenue loss compensation for cancelled train services.

#### *Notification factors and thresholds*

- ORR is minded to extend the scope of the protection provided by paragraph 2.9 of Schedule 4 to enable the recovery of direct costs related to amended or cancelled Type 1 possessions. This is consistent with the way operators can already claim for emerging possession costs not covered by the formulaic cost recovery element of Schedule 4. This should make costs transparent to operators so that they are able to challenge Network Rail's management of possessions and drive costs down.
- ORR is minded to update notification factors to reflect changes to delay multiplier values in the PDFH. This would ensure consistency between the basis for calculating Schedule 4 and 8 payment rates.

*Sustained Planned Disruption (SPD) threshold*

- ORR is minded to keep the SPD revenue loss threshold the same and uplift the cost compensation by inflation (RPI) as it has not received any evidence supporting the view that the current thresholds are inappropriate.

## **4.2. Summary of Network Rail's previous response**

*Notification factors and thresholds*

- In previous responses, we supported the thresholds at which compensation can be 're-opened' ('Type 2' and 'Type 3' possessions, and Sustained Planned Disruption).

*Sustained Planned Disruption (SPD) threshold*

- We considered that the design of the SPD threshold, being a quantitative evidence-based mechanism, has reduced the number of compensation-related disputes compared to previous control periods. We are therefore content for it to remain in place, albeit with some simplification of the contractual wording, as suggested in our September 2011 response. If there was an appetite to redesign the SPD mechanism, we would emphasise the need to ensure that it remains based on quantifiable and realistically measurable definitions of disruption.

## **4.3. Network Rail's current position**

### **Responses to consultation questions**

Q9

Do you agree that the Access Charge Supplement (ACS) should be calculated using Network Rail's revised route based Schedule 4 costs estimation methodology?

In the summer of 2012, Network Rail presented its methodology for forecasting Schedule 4 payments to passenger operators as a result of maintenance and renewals (M&R) works in CP5.

The CP4 approach to calculating the ACS reflected the fact that Schedule 4 payment rates are higher for some TOCs than for others. However, it took no account of planned renewals volumes on each part of the network. The ACSs for CP4 reflected the M&R work done in 2006/07, rather than what was planned for CP4.

For CP5, some improvements on this approach will be possible. The expected Schedule 4 cost will be based on planned activity volumes that are specific to each Route. The allocation of costs to TOCs will therefore be performed at each Route level. In some cases (e.g. Kent, Sussex, Wessex, Scotland) this will mean that the allocation to TOCs is close to 1:1.

However, it should be noted that it remains unclear how closely the actual Schedule 4 payments in CP5 will match the ACSs, even with these improvements, as actual payments will be sensitive to (among other things) the exact locations of



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renewals in CP5; the access strategies developed in collaboration with TOCs; and the extent of enhancement work during CP5.

Q10

Do you consider there is further value in Network Rail achieving greater disaggregation in the methodology of the ACS calculation and, if so, do you have any suggestions how this might be achieved?

The revised methodology represents a significant step forward relative to the accuracy provided by the ACS in CP4. We do not believe that it is practicable to achieve greater disaggregation with any degree of accuracy, although we would of course be willing to consider any suggestions put forward in response to ORR's consultation.

Q11

Do you agree that we should update the estimated bus mile payment rates based on actual amounts paid during CP4, rather than simply uplift the current rates by cost inflation?

We agree with ORR that the level of compensation received by train operators should reflect the actual cost of bus provision they face. We also agree that it is important that the Schedule 4 regime does not lead to perverse incentives for train operators to run buses where the option to run a revised service which would better serve passengers exists. We therefore support ORR's efforts to ensure that the bus mile component of Schedule 4 payments are set at an accurate level.

We support ORR's proposal to revise bus mile compensation based on the actual amounts paid during CP4.

Q12

Do you agree that we should continue with the current formula for calculating revenue loss compensation for cancelled train services when there are replacement buses? If not, do you have any suggestions for how we could improve this aspect of Schedule 4?

The revenue loss formula has worked well to date. We concur with ORR that Schedule 4 cannot deal with complexities surrounding every possession, and should be regarded as an 'average' regime, which will inevitably involve a degree of 'swings and roundabouts'. Indeed, we consider that this feature of Schedule 4 – that it delivers reasonably accurate compensation without involving large administration or transactions costs – is one of its main strengths.

We therefore support ORR's proposals to continue with the current formula for calculating revenue losses.

Q13

Do you consider the way in which the revenue loss formula compensates franchised passenger operators when using replacement buses encourages passenger train operators to run too many buses (rather than trying to run train services using diversionary routes, for example)? If so, please explain why you think this is the case?

We are not aware of any evidence to suggest that passenger operators run too many buses. Our experience is that train operators, and the industry more

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generally, seek to 'do the right thing' for passengers in relation to decisions around running substitute services. However, we consider that it is important that formulae and payments are set at the appropriate level so that compensation is reasonably accurate and incentives are suitable.

Q14

Do you agree that we should extend the scope of the protection provided by paragraph 2.9 of Schedule 4 to enable the recovery of direct costs related to amended or cancelled Type 1 possessions? If not, please tell us why?

When Network Rail cancels a Type 1 possession and an operator reinstates services that would otherwise not have run, operators are not eligible to claim costs that have been incurred or committed (this is in contrast to Type 2 and 3 possessions, where operators are able to claim costs from Network Rail).

We agree with the principle that TOCs should be compensated in instances where Network Rail cancels a Type 1 possession, the operator reinstates the timetable and this causes costs to be incurred. We consider that this would be in keeping with the overall objectives of Schedule 4.

In setting up such arrangements, we will need to be precise about what circumstances are covered so that perversities and unintended consequences and/or behaviours are not encouraged. For example, it would not be appropriate for operators to receive a payment in instances where a cancellation is made in the Possessions Planning System and subsequently rebooked for administrative purposes. Similarly, if possessions are cancelled very shortly after being 'booked', it may not be appropriate for TOCs to claim compensation. Moreover, it would also be inappropriate for a claim to be made if the request for the cancellation originally came from the train operator.

##### *Funding implications*

Local circumstances sometimes change reflecting operational reality and the needs of passengers and freight customers. In other circumstances, safety considerations on the day will mean that a possession has to be cancelled. That is to say, it is appropriate and realistic for a certain level of cancellations of possessions to take place. Examples of situations where cancellation of a possession and the reinstatement of the service is appropriate include:

- Work being delivered more efficiently during an earlier possession, so that subsequent possessions are no longer necessary; and
- Very low temperatures meaning that High-Output Trains cannot be run, whilst passenger and/or freight trains may be able to operate.

If compensation is payable in CP5 when services are reinstated in light of a cancelled possession, it will be important that Network Rail is funded for an appropriate level of cancellations in order to underpin the increased liability.

Equally, it is important that the correct incentives are in place. In the same way that Schedule 4 should avoid creating perverse incentives that discourage operators from running trains, it should also guard against creating perverse incentives for Network Rail to maintain a possession when the 'right thing' is to cancel it. We feel that, if Network Rail was not compensated for a reasonable level of cancellations of

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possessions, the regime could create perverse incentives to avoid cancelling possessions when doing so could be in the interests of efficiency.

We consider that this should be accounted for by means of the Schedule 4 Access Charge Supplement.

##### *Concerns with ORR's proposal*

Whilst we support the principle of compensation for cancelled possessions where costs are incurred, we are concerned that the specific suggestion submitted by ATOC and proposed by ORR in its consultation could entail significant transactions costs to train operators, Network Rail and ORR. The proposal is that operators could claim actual costs incurred or committed when a possession is cancelled and services are reinstated for Type 1 possessions. Type 1 possessions are far more numerous than Type 2 and Type 3 possessions, accounting for approximately 95% of the total. It is therefore likely that widening the scope of paragraph 2.9 of the Track Access Contract, so that operators could claim actual costs, could result in a significant increase in claims that would need to be administered by the industry.

As discussed above, it is important that Network Rail is funded for a reasonable level of cancelled Type 1 possessions in CP5. Under a regime where actual costs can be claimed, assessing the appropriate level of funding will be very difficult, not least because robust historical information on TOC costs is unlikely to be readily available.

In light of these concerns, we would like to propose an alternative to ORR's proposal, whereby operators are compensated on a 'liquidated sums' basis.

##### *Network Rail's proposal*

We propose that Network Rail makes a fixed cash payment to operators where a Type 1 possession is cancelled and services are reinstated. We would expect this to be uplifted for RPI in the same way as the other financial quantities in the Schedule 8 regime are treated. The additional funding requirements for a reasonable level of cancellations should be recovered by means of the ACS.

We consider that this approach has a number of important advantages:

- **Minimising transactions costs.** Such a process could be implemented in a straightforward manner and avoid transactions costs from submitting and reviewing specific claims associated with cancelled possessions.
- **Accuracy of funding and financial certainty.** With fixed payments, developing an accurate estimate of the funding required to deliver a reasonable level of cancellations will be more straightforward (although a problem will remain in relation to estimating the appropriate level of cancellations, since data is scarce). This will also provide financial certainty.

For the avoidance of doubt, we consider that the current arrangements for Type 2 and 3 possessions should remain as they are at present, so that TOCs could continue to make claims for actual costs incurred or committed for Type 2 and 3 possessions. Similarly, for Type 1 possessions, if the operator chose not to reinstate the train service following a cancellation it would be inappropriate to pay additional compensation beyond the standard Schedule 4 level. This is in line with the current arrangements for Type 2 and 3 possessions.

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##### *Next steps*

In order to implement this change to Schedule 4, we would expect to consult with ORR and operators on our proposals through the Schedule 4 and 8 industry group. We will need to consider the appropriate definition of the cancellations, along with the level of the fixed payment to be paid – the latter will need to be based on evidence as far as is possible. We will also need to agree the process for making claims. We will have to estimate the appropriate level of possessions cancellations and estimate the relevant component to the ACS, which would be broadly cost reflective. We acknowledge, of course, that setting the parameters may not be a straightforward exercise, particularly in light of data availability. However, we do feel that this offers a superior approach to a claims based one.

##### Q15

If so, do you agree the threshold for triggering a claim should be £5,000 per possession?

Under our proposal, this will no longer be necessary since operators would be entitled to receive a fixed amount – there would be no materiality threshold.

If ORR was to pursue its proposal to allow operators to claim actual losses, we are concerned that the threshold for claiming of £5,000 could result in excessive transactions costs. We consider that the appropriate level of the materiality threshold is £10,000 (in 2009-10 prices). There is strong precedent for this amount – it is currently the materiality threshold for claims for actual costs for Type 2 and 3 possessions in Schedule 4. This has worked very well in CP4. We see no reason to deviate from this threshold.

##### Q16

Do you agree that we should update the new working timetable notification factor to reflect changes to delay multiplier values in the Passenger Demand Forecasting Handbook (PDFH)? If not, please tell us why?

We agree that it would be appropriate to update the new working timetable notification factor to reflect changes in the delay multiplier values in the PDFH. This is likely to be the best and most timely evidence available. However, as with the recalibration of Schedule 8 payment rates, it will be important for operators to have the opportunity to suggest changes from PDFH values if they believe that other values better reflect the impact of possessions on their revenue.

#### 4. SCHEDULE 4 PASSENGER POSSESSIONS REGIME

Q17

Do you have any further proposals for changes to notification discount thresholds and factors? If so, please explain your reasoning?

We do not have any further proposals for changes to notification discount thresholds and factors.

We would emphasise that it is important that operators, working with ORR, seek to set these at the appropriate level. We welcome operators drawing ORR's attention to any situations where they believe that incorrect price signals and incentives exist. Actions such as this will help ensure that Schedule 4 delivers appropriate price signals to Network Rail, encouraging the appropriate behaviour in terms of possessions planning.

Q18

Do you agree that we should keep the SPD revenue loss threshold the same and uprate the cost compensation by inflation (RPI)? If not, please tell us why?

We believe that the design of the SPD threshold, being a quantitative evidence-based mechanism, has reduced the number of compensation-related disputes compared to previous control periods. In our experience, the workload associated with bespoke claims in relation to Schedule 4 has been significant but manageable in CP4. We consider that the threshold should be updated by RPI in CP5.

It is important to note that SPD is only one of the mechanisms by which operators are protected from the risk of revenue loss being significantly greater than the formulaic Schedule 4 payment. Revenue compensation can also be re-opened in relation to Type 3 possessions.

In addition, some of the most extensive Restrictions of Use associated with major enhancement programmes can be handled via amendments to franchise agreements. In such cases, the operator's access rights (in Schedule 5 of the Track Access Agreement) are amended for the duration of the possession, so no compensation is payable under Schedule 4. Arrangements such as these have been used in CP4, and we understand that DfT is minded to make more use of this type of arrangements in the new round of re-franchising.

A review of the SPD regime arrangements would therefore also have to take account of these other mechanisms. Given that ORR recently reviewed the SPD arrangements, we do not consider that it would be appropriate to spend significant amounts of industry effort revisiting the SPD regime as part of PR13.

Q19

Are you of the view that the provisions for claiming compensation under the SPD mechanism would benefit from clarification? If yes, please highlight which areas should be clarified?

ORR issued guidance in 2010 to clarify the level of each operator's SPD threshold. We believe that formal consolidation of this into the contract would be beneficial as part of PR13. We do not propose to change how this provision works, but believe that simplification of the wording here would help to increase support for the Schedule 4 regime.

## 5. SCHEDULE 4 FREIGHT POSSESSIONS REGIME

### 5.1. ORR's position

In its consultation on Schedules 4 and 8, ORR summarised its position in relation to the following areas.

#### *Compensation for planned disruption*

- ORR is minded not to increase the level of funding of the freight Schedule 4 regime as this would result in an additional cost to the taxpayer. Given that it is open to freight operators to receive additional compensation through payment of an Access Charge Supplement, ORR would need compelling reasons for why increases in compensation for the freight regime should be funded through additional government subsidy.
- As the decision depends on the level of possession activity Network Rail plans to carry out, ORR will need to wait until the publication of the SBP in order to conclude fully on this.

### 5.2. Summary of Network Rail's previous response

In our previous responses to consultations issued as part of PR13, we have stated that the freight Schedule 4 regime works well and that we have no major concerns. We continue to hold this view.

### 5.3. Network Rail's current position

#### Responses to consultation questions

Q20

Do you consider the current regime appropriately compensates freight operators for losses resulting from severe disruption caused by possession? If not, what do you consider the level of compensation should be based on?

In advance of PR08, it became apparent that the freight compensation regime for possessions was not working as effectively as it should, with compensation being provided through a variety of provisions in both Schedule 4 and Part G of the Network Code. In light of this, during PR08 the industry reviewed the freight possessions compensation arrangements, and brought all compensation under the umbrella of Schedule 4. The regime was 'calibrated' so as to provide compensation of £9m per annum (2007-08 prices) to freight operators. There was a provision to revisit the compensation sums after a year of operation if the compensation levels were not broadly accurate. This provision was exercised in 2011, and payment rates were reduced.

In light of the review of compensation sums that took place earlier in CP4, we consider that the current regime provides an appropriate level of compensation to freight operators when Network Rail takes possession of the network. In particular, we consider that the current regime provides broadly the same level of compensation as would have previously been in place under the CP3 arrangements.

## 5. SCHEDULE 4 FREIGHT POSSESSIONS REGIME

Q21

Do you consider that the current regime appropriately incentivises Network Rail to reduce the amount of disruption faced by freight operators due to possessions? If not, how do you think incentive effects can be strengthened?

We consider that the current regime appropriately incentivises Network Rail to reduce the amount of disruption faced by freight operators due to possessions. We believe that the current possessions regime incentivises the right balance between efficiency and disruption to freight services.

We understand freight operators' concerns that if Schedule 4 payment rates to freight operators do not increase by the same proportion as those for passenger operators in CP5, distortions could result. We would be happy to consider offering freight operators increased Schedule 4 compensation in exchange for payment of an ACS. Such arrangements work well in relation to the passenger regime, and some freight operators have opted for such arrangements to receive increased compensation for unplanned disruption through Schedule 8. We would be open to considering an arrangement which applied generically across freight operators, or one which relates to specific operators which consider that the high value of goods being carried merits a payment rate which is higher than the typical one.

Q22

If Schedule 4 compensation payment rates for freight operators were increased, should this be funded by the government? If so, please explain why you think this should be the case.

As noted above, we would be happy to provide increased compensation to freight operators, to be funded by means of an ACS, in CP5.

The railway continues to face a significant efficiency challenge, and we are committed to delivering savings to taxpayers in CP5. With this challenge in mind, we do not believe that it would be appropriate to increase government funding for compensation for possessions to freight operators.

## 6. SCHEDULE 8 PASSENGER PERFORMANCE REGIME

### 6.1. ORR's position

In its consultation on Schedules 4 and 8, ORR summarised its position in relation to the following areas.

#### *Compensation during Sustained Poor Performance*

- ORR is minded to keep the current wording of Schedule 8 about the scope of what can be included in claims made under the SPP arrangements, due to difficulties associated with identifying all types of claims that could arise. Also, it is of the view that the current wording provides an appropriate level of clarity.
- ORR's emerging view is that, while it is difficult to determine exactly where the SPP threshold should be set, it is currently too easily triggered and this represents a risk for Network Rail.
- ORR is minded to increase the SPP threshold but would welcome any practical proposals from stakeholders on how it could determine what level the SPP threshold should be set at.

#### *Whether to introduce a time delay on Schedule 8 payments*

- ORR is minded not to introduce a change to the timing of Schedule 8 payments (payments remain due within 35 days following the end of four-week rail accounting periods), as this would introduce complexity and an administrative burden without materially improving industry incentives or the operation of Schedule 8.

#### *Whether paragraph 17 of Schedule 8 should be amended to reduce the number of circumstances in relation to which train operators may request changes in payment rates*

- ORR is minded to not change the circumstances in which Network Rail and train operators can propose amendments via paragraph 17 as it does not believe that paragraph 17 is being widely misused and there could be legitimate reasons for proposed changes.
- ORR intends to review the text of paragraph 17 and make clarifications where it is unclear.

#### *Compensation for passenger charter payments*

- ORR is minded to remove the passenger charter element of Schedule 8. This will simplify the regime and reduce the costs of updating Schedule 8 payment rates, as the sums of money involved are not significant enough to justify recalibrating the charter payment rates.



## 6. SCHEDULE 8 PASSENGER PERFORMANCE REGIME

### *Methodology for calculating improvement trajectories to Network Rail benchmarks*

- A methodology will need to be developed by Network Rail to calculate improvement trajectories for CP5. However, it is currently too early to do this as ORR is still considering the nature of the output targets it is going to set. This will follow publication of Network Rail's SBP.

### *Treatment of cancellations by train operators of their own trains*

- ORR is not of the view that the way Schedule 8 currently treats train operator cancellations of their own train services is something which will materially impact on incentives in a way that disadvantages passengers.
- ORR is minded therefore to continue to treat train operator cancellations to their own trains in the same way as currently.

## **6.2. Summary of Network Rail's previous response**

- In previous responses, we argued that PR13 should focus on maintaining a simple and stable default passenger performance regime at national level, with any significant amendments left to local alliancing discussions. Any network-wide changes to the regime would always need to be considered as part of a broader discussion about risk allocation and incentives, as many of the emerging suggestions would have a consequential impact on other parts of the contractual framework if done in isolation.
- We suggested a number of additional aspects for refinement, with the shared aim of better aligning the commercial incentives of industry parties with the 'right thing to do' for the users of the rail network.

### *Compensation during Sustained Poor Performance*

- We welcomed the opportunity to review the SPP threshold within Schedule 8 which addresses extreme performance disruption over a long period. We considered that the present SPP threshold (10% of benchmark) is set too tightly, which has contributed to the trend towards an increasing number of bespoke claims, undermining the effectiveness of the liquidated sums based regime.

### *Whether to introduce a time delay on Schedule 8 payments*

- We welcomed the discussion around introducing a lag on Schedule 8 payments, but noted that this does not alter the underlying economics of the regime and would not change the value of payments in the long run.

### *Whether paragraph 17 of Schedule 8 should be amended to reduce the number of circumstances in relation to which train operators may request changes in payment rates*

- We re-emphasised the importance of securing full industry support for the approach to the recalibration exercise, and for the results of the work, in order to avoid the risk of disruptive revisiting of data during CP5. This recalibration would reduce the scope of paragraph 17 of Schedule 8 for making mid-term changes to parameters and would create greater incentives for parties to engage at the recalibration stage. One advantage of this would be an

## 6. SCHEDULE 8 PASSENGER PERFORMANCE REGIME

improvement in the quality of the data for the start of CP5. We considered that paragraph 17 should return to being the recourse for data quality issues caused by material changes to train services.

### 6.3. Network Rail's current position

#### Responses to consultation questions

Q23

Do you agree that we should keep the current Schedule 8 contractual wording in relation to what train operators can claim for under the SPP arrangements? If you do not agree, do you have any proposals for alternative wording?

In its consultation document, ORR states that its emerging view is that SPP compensation should continue to only be available to claim for losses which are a *direct* result of SPP.

ORR has stated that the current contractual wording provides an appropriate level of clarity, especially in relation to what constitutes 'relevant losses'. We agree with ORR's view that it would be very difficult to identify every situation under which an operator could reasonably claim through the SPP arrangements. As such, we agree that it would not be practical to define a 'list' of circumstances where relevant losses could arise, without imposing undue risk on operators. Similarly, we agree that defining what operators cannot claim for could give rise to an interpretation that operators can claim for everything which is not included in that definition. This could give rise to an inappropriate level of risk to Network Rail.

The fact that it will not be practicable to make any substantive changes to the scope of the SPP arrangements in CP5 makes setting the threshold above which operators can potentially make claims under the SPP provisions all the more important. We discuss this issue in the next question.

Q24

Should we continue with the SPP threshold set at 10% or increase it? If not, please tell us why?

As stated in ORR's PR08 determination, the SPP threshold:

*"should represent the level of poor performance where compensation under the standard Schedule 8 arrangements is materially less than what is needed to reflect the actual impact on the train operators".*

We agree with this statement and believe that it is appropriate that train operators should be protected from the financial impacts of sustained poor performance.

Like ORR, we recognise the importance of setting the threshold at a level such that it is not triggered by short-term fluctuations in performance, as this could give rise to excessive levels of bespoke claims and undermine the liquidated sums nature of Schedule 8.

We have submitted evidence to ORR which shows that large numbers of TOCs are above the SPP threshold given its current level. To some extent, this is because Network Rail has fallen behind its CP4 performance targets in the last two years. However, we have undertaken analysis which suggests that even when this effect

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is taken into account, the proportion of TOCs above the threshold remains high. We have shared this analysis with ORR, and these findings have been confirmed by consultants Steer Davies Gleave (see below).

We consider that in recent years the SPP threshold has been triggered too often, and we strongly agree with ORR that this is inappropriate given the purpose of the SPP arrangements. Like ORR, we are of that view that the SPP threshold should be increased for CP5.

We see there as being many reasons for this:

- The frequency with which the SPP threshold is breached at present undermines the liquidated sums nature of the SPP regime. Whilst the regime has imposed modest transactions costs in CP4 to date, we feel strongly that many of these costs incurred have been unnecessary. Moreover, we are concerned that the volume of claims, and the associated transactions costs, could increase over time.
- The fact that, at its current level, large numbers of operators are above the SPP threshold places additional financial risk on Network Rail. We believe that the risk imposed by the SPP arrangements, given the current threshold, is inappropriate and may result in inefficiencies. As noted above, at current levels many operators are above the SPP threshold simply because of ordinary fluctuations in performance, which SPP arrangements are not intended to capture. Consequently, Network Rail is incentivised to hold a level of contingency to guard against SPP claims beyond what is intended by the SPP regime. These resources could be put to better use elsewhere. As such, we consider that the current arrangements do not encourage an efficient allocation of resources.
- The current SPP threshold creates perverse incentives in terms of the initial calibration of Schedule 8. As the threshold is so easily exceeded, operators are not fully incentivised to ensure the correct calibration of Schedule 8 in the first instance as they can instead rely on making bespoke SPP claims if they believe the payment rates are incorrect.

Q25

If we increase the SPP threshold, what are your views on the level we should set it at?

We consider that there is a clear case for increasing the SPP threshold in CP5. However, deciding on the appropriate level poses challenges. To date, the level has been set on the basis of judgement and negotiation between industry parties.

When the SPP threshold was first introduced, performance levels were much lower than those we are experiencing today. At today's performance levels and associated benchmarks, which are both substantially 'better' than in CP3, the 10% SPP threshold means that operators are eligible to make a claim despite performance being close to the highest levels ever achieved.

To inform the appropriate level of the threshold, we have commissioned independent consultants Steer Davies Gleave to provide analysis to inform the appropriate choice of SPP threshold in CP5. We chose Steer Davies Gleave to undertake this work since it is well-known for providing robust and impartial

## 6. SCHEDULE 8 PASSENGER PERFORMANCE REGIME

analysis in relation to setting the parameters of Schedules 4 and 8. For example, Steer Davies Gleave undertook the analysis on behalf of ORR earlier in PR13 to help guide the discussion as to whether Schedule 4 and 8 payment rates should be set below 100% compensation levels. The Executive Summary of Steer Davies Gleave's report is provided in the annex to this response. We have shared the full analysis with ORR.

Steer Davies Gleave's recommendation is that the SPP threshold should be raised from 10% of benchmark to 30%. Its rationale for setting the benchmark at this level is based on:

- A consideration of the purpose of the SPP mechanism;
- A review of the evidence for the effect of poor performance;
- A review of the history of SPP claims in CP4;
- An assessment of the risk to TOCs associated with the threshold; and
- An assessment of the risk to Network Rail associated with the threshold.

The justification for setting the benchmark at the 30% level offered by Steer Davies Gleave is that:

- At this level, the risk to TOCs of suffering losses significantly in excess of the standard Schedule 8 compensation is small;
- Below this level there is a risk that the standard Schedule 8 regime would be undermined, with Network Rail facing a significant number of claims in instances where it is performing at benchmark levels in aggregate; and
- The level is broadly consistent, in terms of the performance levels at which SPP would be triggered, with previous threshold levels at the end of CP3. It was therefore accepted at that time that standard Schedule 8 payments were adequate at these levels of performance.

On the basis of Steer Davies Gleave's analysis and recommendation, we consider that the SPP threshold should be set at 30% in CP5. We note that the analysis undertaken by Steer Davies Gleave is the first attempt to provide an evidence-based view of the appropriate level of the SPP threshold. We therefore consider that the work provides the most compelling basis available for the appropriate level of the SPP threshold in CP5.

In addition to this, we note that an SPP threshold of 30% would correspond approximately to a PPM of around 91%. Network Rail's Strategic Business Plan proposes a range of performance of 91 – 93% PPM. It would therefore seem appropriate and judicious for the threshold to be set at 30%, so that claims could be made if performance deteriorates to a level outside of the range proposed in the SBP.

## 6. SCHEDULE 8 PASSENGER PERFORMANCE REGIME

Q26

Do you agree that we should leave timings of Schedule 8 payments unchanged, with payments due within 35 days following the end of each four-week accounting period? If not, please tell us why?

Whilst we recognise that there is a time delay on impacts on operator revenue resulting from periods of poor performance, we consider that introducing such a delay on Schedule 8 payments would significantly increase complexity in the regime and also introduce an administrative burden. Discussions with operators have suggested that they do not believe that a time delay would impact on industry incentives.

We do not consider that the gains from changing the timing of payments would outweigh the costs and additional complexity. We therefore agree with ORR's proposal to leave timings of Schedule 8 payments unchanged for CP5.

Q27

Do you agree that we should keep the circumstances in which Network Rail and train operators can propose amendments to Schedule 8, appendix 1 via paragraph 17 the same? If not, please tell us why?

Paragraph 17 of Schedule 8 currently enables parties to amend appendix 1 data at any stage, subject to ORR approval. Network Rail believes that paragraph 17 is an important mechanism which enables parties to proceed with confidence about the ongoing validity of the data used to deal with the financial impacts of disruption.

During 2012, Network Rail proposed that the circumstances in which Network Rail and train operators can propose amendments via paragraph 17 should be made narrower. We are disappointed that ORR is minded not to implement the suggestions made by Network Rail.

ORR has acknowledged that making changes to appendix 1 data can result in transactions costs and that there is evidence that changes may sometimes be sought for commercial gain rather than issues of data accuracy. However, a central argument put forward by Network Rail for tightening the requirements of paragraph 17 is that the current wording undermines the recalibration process. In particular, since the current wording permits the revisiting of appendix 1 under any circumstances, the incentives to get the parameters 'right' through the periodic review calibration are diminished. Our view is that the current wording discourages sufficiently active engagement in the recalibration process.

In light of this, we believe that ORR should reconsider whether to make the wording of paragraph 17 more restrictive. Whilst doing so may be too late to promote further engagement in the calibration for CP5, we believe that it will assist in future calibrations of Schedule 8.

Q28

Are there any specific areas of paragraph 17 where you are of the view the drafting needs to be made clearer?

Clearly some appendix 1 data may need to be changed during a control period, and the contract should continue to allow this. In order to ensure that changes are requested only where it is of clear benefit to the accurate functioning of performance regime, and to encourage upfront engagement in the recalibration

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exercise during the periodic review process, we propose that the changing of Network Rail payment rates should be permitted only:

*to the extent that a proposed change to payment rates is the result of a change to the timetable (this may include significant changes to service patterns, or full scale remapping).*

Network Rail believes that this drafting should be included within paragraph 17, applying to *Network Rail payment rates only*. Alternatively, ORR could consider including a reference within its Criteria & Procedures document.

Network Rail believes that this would represent an improved way forward for the industry, and it would continue to allow TOCs to refresh relevant appendix 1 data wherever genuinely necessary.

This proposal is not intended to place limitations on any reasonable application of paragraph 17. TOCs are invited to identify whether they feel any additional reasonable criteria would be required for when Network Rail payment rates may be amended.

Q29

Are you content for us to remove the passenger charter element of the Schedule 8 performance regime? If not, please could you tell us why and whether you would like us to take any alternative course of action?

We agree with ORR's proposal to remove the passenger charter element of the Schedule 8 performance regime. The passenger charter was established at a time when performance was significantly worse than the levels experienced today. Nowadays, its provisions are rarely triggered. The funds changing hands through passenger charter arrangements are very small, and the continued administration required from TOCs, Network Rail and ORR does not warrant the continuation of these arrangements.

Q30

Do you agree that we should not change the way train operator cancellations to their own trains are treated under Schedule 8? If not, please tell us why?

We agree that we should not change the way we treat train operator cancellations to their own services. Any changes to the way this is treated would require an update to the PEARS system and also an adjustment to the data used to recalibrate Schedule 8 benchmarks. The associated costs could be considerable. Discussions with TOCs, which are the parties that would be most affected by such a change, indicate that any positive impact on incentives would be negligible at best.

## 7. SCHEDULE 8 FREIGHT PERFORMANCE REGIME

### 7.1. ORR's position

In its consultation on Schedules 4 and 8, ORR summarised its position in relation to the following areas.

#### *Network Rail benchmark*

- ORR proposes to update the Network Rail benchmark so it reflects the performance targets it sets for Network Rail for CP5, including any improvement trajectories.
- ORR proposes to work with the freight Schedules 4 and 8 industry group to develop a robust methodology for this.

#### *Network Rail payment rate*

- ORR is minded to keep the Network Rail payment rate the same but uplift it for inflation.

#### *Network Rail cancellation payments*

- ORR is minded to keep the Network Rail cancellation payment rates the same but uplift them for inflation.
- ORR is minded to keep a threshold representing the average number of cancellations, above which the higher payment would apply.

#### *Freight operator benchmark*

- ORR plans to update the freight operator benchmark so it reflects the performance of freight operators during the two year recalibration period being used to recalibrate the Schedule 8 payment rates. This is consistent with the passenger regime.
- ORR supports Network Rail's proposal to update the congestion factor to reflect the findings of analysis being carried out for the update to the capacity charge. This analysis will result in a congestion factor based on much more robust evidence than the existing one.

#### *Freight operator payment rates*

- ORR proposes to continue with the methodology that was used in PR08 but weight the Network Rail £ per delay minute payment rates by third party freight operator delay affecting each service group. The resulting freight operator payment rate would better reflect the actual impact of delays caused by freight operators to other train operators.

## 7. SCHEDULE 8 FREIGHT PERFORMANCE REGIME

### *Bonus payment rates*

- ORR is minded to continue with bonus rates at 50% of the compensation payment rates as this offers some protection to freight operators when Network Rail is performing above benchmark.

### *Incident cap menu*

- ORR is minded to remove the requirement on Network Rail to offer incident caps in return for an Access Charge Supplement, as the main role of the Schedule 8 regime is to protect operators from the risks arising from actions of Network Rail and third-party train operators.

### *Annual liability caps*

- ORR is minded to continue to allow operator specific annual liability caps as they offer an important protection to freight operators and Network Rail.

## **7.2. Summary of Network Rail's previous response**

The freight Schedule 8 regime was overhauled as part of PR08. In our previous consultation responses, we have stated that overall, we believe that the regime works well.

## **7.3. Network Rail's current position**

### **Responses to consultation questions**

Q31

Do you agree that we should keep the Network Rail payment rate the same, but uplifted for inflation? If not, please tell us why?

As a general principle, it is important that the new rates are accurate and well-founded empirically. This will ensure that compensation is appropriate, that incentive effects are suitable and that price signals are accurate. It is important that we do not consider each aspect of the regimes in isolation, due to potential impacts elsewhere (for example, the Network Rail payment rate feeds passenger operator payment rates together with freight operators' own payment rate to Network Rail).

We are content with ORR's proposal to keep the Network Rail payment rate the same, uplifted for inflation (RPI). To date, this has worked well. Unless robust evidence can be provided to suggest more appropriate rates, the payment rates should not change. We note that the payment rate uplifted for inflation will fall within the middle of the range suggested by ORR's review of access policy<sup>7</sup>. This provides further assurance that the current payment rate is broadly right.

<sup>7</sup> Available here <http://webarchive.nationalarchives.gov.uk/20111108204718/http://www.rail-reg.gov.uk/server/show/nav.2254>



## 7. SCHEDULE 8 FREIGHT PERFORMANCE REGIME

Q32

Do you think that the current Network Rail payment rate accurately reflects the financial impacts incurred by freight operators as a result of Network Rail caused delays to freight trains? If not, please tell us why?

For CP4, the payment rate was set by ORR after consultation with freight operators. We note that the payment rate will be updated for RPI. In the absence of evidence to the contrary, we have no reason to believe that the payment rate does not reflect the financial impact on operators of Network Rail caused delay.

Q33

Do you agree that we should re-examine the evidence base for the Network Rail payment rate with the freight industry and Network Rail in CP5, and if necessary adjust the rate to reflect cost and revenue impacts on freight operators due to Network Rail caused delays? If not, please tell us why?

As an industry, we should seek to ensure that the payment rates are as robust as is practically possible and based on empirical evidence. We understand that there is insufficient time to examine and implement a new verification exercise for CP5. As such, we consider that it is appropriate to re-examine the evidence base for the Network Rail payment rate for implementation in CP6, and we welcome ORR's proposal to do so.

As part of this exercise, the industry should review whether the Network Rail payment rate in the freight regime is intended to cover revenue effects, cost effects or both. The compatibility with the passenger regime should be considered in answering this question.

Q34

Do you agree that we should keep the Network Rail cancellation payments the same but uplift them for inflation? If not, please tell us why?

We agree with ORR's proposal to keep the Network Rail cancellation payments the same, but uplifted for inflation (RPI). We consider that, to date, this has worked well and we do not have any compelling evidence to suggest that the cancellation payments are no longer appropriate.

It is important that the approach taken with respect to the Network Rail cancellation payments is the same as that used for the Network Rail payment rates.

Q35

Do you agree that we should update the congestion factor used in the calculation of adjustments to the freight operator benchmark, in order to take into account of evidence being collected as part of the update of the capacity charge? If not, please tell us why?

Network Rail has proposed that the congestion factor used to adjust the freight operator benchmark to reflect traffic growth should be based on evidence, rather than an arbitrary figure selected by the industry at the time of the last periodic review. We note that this proposal received broad support from freight operators when discussed at the Schedules 4 and 8 freight industry group in the autumn of 2012.

## 7. SCHEDULE 8 FREIGHT PERFORMANCE REGIME

Following discussions with ORR and freight operators, we have commissioned Arup to examine the congestion factor, and this work is ongoing. The work is being undertaken as part of a wider piece of analysis to recalibrate the capacity charge, which involves similar data and relationships.

We agree with ORR that freight operators should be engaged as part of this work. We have asked Arup to present their analysis at an upcoming freight Schedules 4 and 8 industry group, and Arup will be inviting comments from the freight community on an ongoing basis.

Q36

Do you agree that the Network Rail £ per delay minute payment rates used in the calculation of the freight operator payment rate should be weighted by third party freight operator delay affecting each service group? If not, please tell us why?

In PR08, the split of Network Rail direct delays was used to calculate a weighted average of train operator payment rates, which formed the basis for the freight payment rate. This was the best option available at the time.

For CP5, we have proposed that a more suitable method would be to calculate the passenger operator weighted average based on historical delay data. This method would give rise to more cost-reflective payment rates and would be more representative of the payments made through the 'star model'.

We have also proposed that the weighted average is calculated at the level of service group rather than TOC in CP5, which should further increase accuracy.

Q37

Do you agree with our proposal to continue to set the bonus payment rates at 50% of the level of the compensation payment rate? If not, please tell us why?

We do not agree with ORR's proposal to set bonus payment rates at 50% of the level of the compensation payment rate. Rather, bonus rates should be set at 100% of the compensation payment rate. We note that our view that the freight Schedule 8 regime should be symmetric is shared by all of the major freight operators. We therefore consider that it would be appropriate for ORR to reverse its 'minded-to' position in relation to this issue.

ORR states that the primary purpose of the 50% bonus payment rate is to protect small operators and new entrants. We fully support the need to promote competition in the freight market, and protect smaller operators or prospective entrants from undue risk through Schedule 8.

We believe that this could be best achieved by means of bespoke arrangements with smaller operators or market entrants, rather than imposing a broad-brush arrangement across the freight industry. For example, we could consider entering a performance regime with smaller operators that was symmetric, but possessed a lower 'gearing' in order to contain operators' risk.

There are many reasons why we consider that a symmetric regime would be more appropriate.

## 7. SCHEDULE 8 FREIGHT PERFORMANCE REGIME

### *Changes in marginal incentives*

The asymmetry of the regime, suggested by ORR, will distort the marginal incentives to operators and Network Rail – parties' marginal incentives will depend on 'where' they are performing, relative to the benchmark. If Network Rail was performing above benchmark, it would be less incentivised to improve performance than it would be if it was performing below benchmark.

A related point is that, under an asymmetric regime, the location of the benchmark (which is the location of the 'kink' under ORR's proposal) becomes all the more fundamental since it determines marginal incentives. Whilst every effort will be made to ensure that the benchmark is set appropriately in CP5, a degree of uncertainty will remain. We should guard against a situation in which parties' incentives are affected by the vagaries of the benchmark setting process. This can be achieved by setting a symmetric payment curve.

### *Non-neutrality of the regime*

Adopting a 50% bonus payment rate could result in net payment flows within the regime, so that the regime may not be financially neutral even when Network Rail and operators are performing at benchmark on average.

We would expect that fluctuations of performance around the benchmark will follow some statistical distribution, which may be symmetric. In such a situation, if Network Rail performs at benchmark on average, 50% of the time it will be above the benchmark and 50% of the time it will be performing worse than the benchmark. So, in 50% of cases it will be paying operators the full compensation payment rate, and in the remaining 50% of cases it will be receiving half of this amount through the bonus payment. Therefore, in aggregate, Network Rail can expect to make a net payment to operators despite hitting performance-related targets on average. The same is true on the freight side of the regime, so that FOCs will on average make a net payment to Network Rail.

The overall effect of this for both freight operators and Network Rail is unclear given that CP5 payment rates remain unknown. It could be the case that the net payments on the freight operator side and the Network Rail side 'balance out', resulting in no overall impact. However, this will only happen by coincidence. To the extent that these effects do not 'cancel out', we would need to consider manual adjustments to the regime. This involves considerable complexity and should be avoided by setting a symmetric payment rate.

### *Evaluating 'business cases' for performance improving initiatives*

A further problem associated with ORR's proposed asymmetric regime is that it makes the evaluation of 'business cases' for performance improving initiatives difficult and uncertain. This is because, ex-ante, whether performance is above or below benchmark is typically unknown. This means that the financial value of performance improvement is uncertain. This problem applies in equal measure to both Network Rail and freight operators. Moving to a symmetric regime removes this problem.

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Q38

Do you agree with our proposal not to require Network Rail to offer incident caps in return for an access charge supplement? If not, please tell us why?

We support ORR's proposal not to require Network Rail to offer incident caps in return for an Access Charge Supplement. As a matter of principle, it is not clear that Network Rail should be regarded as a monopoly provider of insurance against incidents which cause severe delay. In addition, it remains unclear as to whether the imposition of liability caps is helpful in terms of incentivising optimal behaviour from operators.

However, we remain committed to responding to the needs of our customers, and we would not rule out entering the 'market' for limiting operators' risks in relation to Schedule 8 liabilities.

Q39

Do you agree that incident caps are something that could be provided by the private insurance market if Network Rail were not to offer incident caps at a reasonable price? If not, please tell us why?

In principle, the private insurance market may be able to provide insurance to operators which wish to cap their liability when they cause delay. We consider that freight operators are best placed to provide evidence-based responses to this question.

Q40

Do you agree that we should continue to allow operator specific annual liability caps? If not, please tell us why?

Operator-specific annual liability caps were set at the start of CP4 based on discussions between the operators and Network Rail. These caps prevent a large flow of money from one industry party to another over the course of a year. Provided that benchmarks are set correctly at the start of the control period, financial flows between Network Rail and operators should be neutral, so these annual caps should, in theory, not be breached.

We agree with ORR's proposal to continue to allow operator specific annual liability caps, as this provides assurance to the industry by limiting financial liability and reducing risk.

We consider that it may be appropriate to introduce a mechanism which allows the annual liability caps to be updated when freight operators change in size. In CP4 to date, some operators have grown significantly, meaning that the annual liability cap is too easily breached. This may undermine the suitability of such caps.

Q41

Should we continue to set reciprocal annual liability caps for smaller and new freight operators? If not, please tell us why?

The regime has worked well in CP5. We see no strong reason for changing it.

We consider that it is appropriate to continue to set reciprocal annual liability caps for smaller and new freight operators. The principal reason for this is to not discourage market entry for new freight operators which may be put off by an

## 7. SCHEDULE 8 FREIGHT PERFORMANCE REGIME

excessive level of risk. It is possible that, without these annual liability caps, prospective entrants would decide against entering the market.

Q42

Should we continue to set reciprocal annual liability caps in instances where Network Rail and freight operators cannot agree on the level the cap should be set at? Or are caps on annual liability something the private insurance market could provide if no agreement is reached?

The regime has worked well in CP5. We see no strong reason for changing it in relation to the provision of annual liability caps.

## 8. COMPENSATION RELATED TO CHARTER OPERATORS

### 8.1. ORR's position

In its consultation on Schedules 4 and 8, ORR summarised its position in relation to the following areas.

#### *Charter operator payment rate*

- ORR is minded to develop a specific charter operator payment rate, based on the methodology used to calculate the freight operator payment rate as there is now data available to do this. This would result in a charter operator payment rate that better reflects the actual impact of delays caused by charter operators to other train operators.

#### *Incident caps*

- ORR is minded to remove the requirement on Network Rail to offer incident caps to charter operators. ORR is also minded to remove the cap on Network Rail incidents (although this is not actually employed in practice). This is because incident caps are protecting charter operators against risk relating to their own performance.

#### *Network Rail payment rate*

- ORR plans to set the Network Rail payment rate for charter operators so it is the same as the Network Rail payment rate under the freight regime, as there is not much evidence on the size of the impact of delays to charter operators on long term revenue.

### 8.2. Network Rail's current position

#### Responses to consultation questions

Q43

Do you agree that a separate charter operator payment rate should be calculated using the same methodology used to calculate the freight operator payment rate, but based on delays caused by charter operators to other train operators? If not, please tell us why?

The current charter operator payment rate is set equal to the freight operator payment rate. We consider that this does not reflect the actual costs incurred from a charter train incident as freight and charter operators run fundamentally different services which have very different interactions with other operators on the network. Freight trains sometimes run overnight when the network is quieter, and have little interaction with other network users. Conversely, charter trains often run alongside passenger trains from major stations.

As such, we agree with ORR's proposal to calculate a separate charter operator payment rate using the same approach as in the freight regime. This will ensure consistency through the regimes and will produce a payment rate which is more cost reflective than the current one.

## 8. COMPENSATION RELATED TO CHARTER OPERATORS

Q44

Do you agree with our proposal not to require Network Rail to provide incident caps to charter operators on the basis that this currently results in a subsidy to charter operators? If not, please tell us why?

Under the current regime, charter operators have an incident cap of £5,000. They do not pay an Access Charge Supplement in exchange for this liability cap. We agree with ORR's proposal not to require Network Rail to provide incident caps to charter operators.

As a matter of principle, if it were decided that charter operators would still receive the incident cap without paying an Access Charge Supplement, this should be made explicit and transparent, by providing for this in Network Rail's funding requirement.

Q45

Do you agree that incident caps are something that could be provided to charter operators by the private insurance market? If not, please tell us why?

In principle, the private insurance market may be able to provide insurance to operators which wish to cap their liability when they cause delay. We consider that charter operators are best placed to provide evidence-based responses to this question.

Q46

Are you content for us to set the Network Rail payment rate in the charter operator performance regime so it is the same as the Network Rail payment rate in the freight performance regime? If not, do you have any proposals on how we should update it including on the evidence we could use?

Ideally, we would have a separate charter operator and freight operator payment rate. This would reflect the financial impacts on charter operators as a result of delays caused by Network Rail, and would be based on robust analysis.

However, we consider that it will not be possible to calculate and implement this for CP5 given the absence of further information. Therefore, we accept ORR's proposal to set the Network Rail payment rate in the charter regime to be equal to that of the freight regime.

We note that ORR is due to undertake detailed analysis in the course of CP5 to determine the Network Rail payment rate to freight operators, and consider that it may be appropriate to consider the Network Rail payment rate to charter operators as part of this analysis.

Q47

Are you of the view that there are any other areas of the charter Schedule 8 performance regime that should be amended? If not, please tell us why?

We do not currently consider that it is necessary to amend other areas of the charter Schedule 8 performance regime.

# ANNEX – STEER DAVIES GLEAVE EXECUTIVE SUMMARY

## Executive Summary

### *The Sustained Poor Performance mechanism*

1. The Sustained Poor Performance (SPP) mechanism is designed to provide protection to Train Operating Companies (TOCs) when performance falls to such a level that compensation under the standard Schedule 8 arrangements is considered to be inadequate. The mechanism provides for a TOC to claim for relevant losses, to the extent that these are not already compensated under the standard Schedule 8 arrangements, and may be invoked when performance averaged over 4 quarters (13 periods) is worse than a defined threshold.
2. Currently the SPP threshold is set so that additional compensation could be claimed when Network Rail performance is at least 10% worse than benchmark over a period of 12 consecutive months.

### *Consultation on Schedules 4 and 8 possessions and performance regimes*

3. The Office of Rail Regulation (ORR) has released an industry consultation on Schedule 4 and 8 possessions and performance regimes (26<sup>th</sup> November 2012). ORR has stated in this consultation that it considers that at the current threshold, SPP is too easily triggered and is therefore minded to increase the threshold. The consultation invites respondents to give a view as to the level at which the threshold should be set.

### *Recommendation for SPP threshold*

4. Our recommendation is that the SPP threshold should be raised from 10% of benchmark to 30%.

### *Rationale for recommendation*

5. This recommendation is based on:
  - | A consideration of the purpose of the SPP mechanism;
  - | A review of the evidence for the effect of poor performance;
  - | A review of the history of SPP claims in CP4;
  - | An assessment of the risk to TOCs associated with the threshold; and
  - | An assessment of the risk to Network Rail associated with the threshold.
6. The justification for setting the benchmark at the 30% level is that:
  - | At this level, the risk to TOCs of suffering losses significantly in excess of the standard Schedule 8 compensation is small;
  - | Below this level there is a risk that the standard Schedule 8 regime would be undermined, with Network Rail facing a significant number of claims in instances where it is performing at benchmark in aggregate; and
  - | The level is broadly consistent, in terms of the performance levels at which SPP would be triggered, with previous threshold levels in CP3. It was

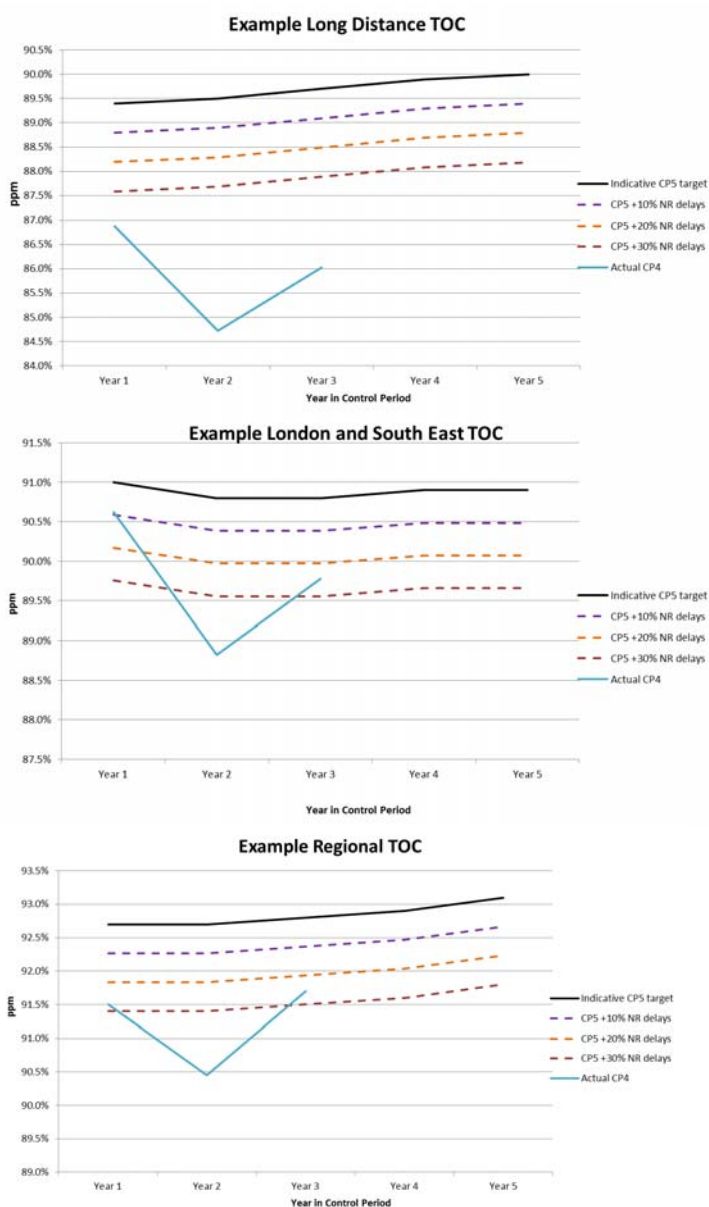


therefore accepted at that time that standard Schedule 8 payments were adequate at these levels of performance.

*Risk to TOCs*

7. The SPP threshold is intended to represent the level of poor performance where compensation under the standard Schedule 8 arrangements is materially less than what is needed to reflect the actual impact on the train operator. This implies that there is a non-linearity between performance and revenue whereby, in theory at least, a worsening beyond a given threshold potentially affects passengers by a greater proportion than within that threshold, or that significant additional costs arise when performance falls below a certain threshold. A review of the Passenger Demand Forecasting Handbook found no evidence to indicate where, if at all, non-linearities might start to be experienced. Furthermore, no claims were made in CP4 based on the effects of such non-linearities on revenue, and only one claim (which would have been allowed with a threshold of 30%) referred to costs. The evidence suggests that, unless there is a collapse in performance levels, the compensation under the standard Schedule 8 regime is adequate.
8. The graphs below illustrate that if performance in CP5 were below benchmark to the extent that SPP were triggered at a 30% threshold, PPM would still be of the same order as has been experienced during CP4 (the graphs show actual, rather than target, performance in CP4).
9. With a 30% threshold, sustained very poor performance on just one third of a TOC's service groups is likely to trigger SPP for the TOC.

FIGURE 0 PPM IN CP4 AND CP5



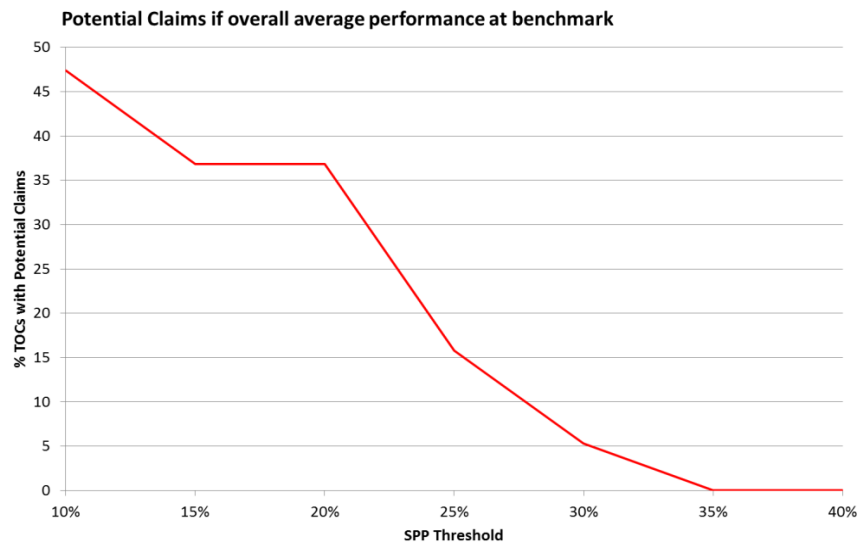
10. There is no evidence that performance at the levels currently experienced (and hence what might be experienced by TOCs just within the threshold were it set at 30% for CP5) causes an increase in TOC costs or a reduction in revenues beyond the levels compensated by the Schedule 8 formulae.
11. A single claim was settled in CP4; this claim would still have been possible with an SPP threshold of 30%.

*Risk associated with number of claims*

12. A key strength of Schedule 8 is its liquidated sums nature which is simpler and less costly to administer than a bespoke claims process. This would be undermined if claims could too readily be triggered under SPP. The graph below shows the percentage of TOCs which would have been eligible to make a claim during 2011/12 if Network Rail were performing at benchmark levels in aggregate in 2010/11 and 2011/12 (but with the same degree of variability - as

observed in those years - between service groups and from one period to another.)

FIGURE 2 POTENTIAL CLAIMS



13. The graph shows that where Network Rail is performing at benchmark in aggregate there would be a substantial risk of claims, with attendant significant costs in terms of management time, if the threshold were set at a level below 30%.
14. There is also a significant financial risk to Network Rail associated with SPP claims; this risk reduces as the SPP threshold is increased.

*Consistency with former SPP threshold levels*

15. During CP3 the SPP threshold was set between 25% and 20%. Performance benchmarks have become more demanding over time, therefore in terms of the level of performance which would trigger SPP, a level of 30% in CP5 would correspond to a threshold of less than 20% in CP3. This is illustrated by the fact that lateness at 30% above 2012/13 benchmarks is less, for all but one service groups, than lateness at 20% above 2009/10 benchmarks.