

Chris Hemsley

Deputy Director, Railway Markets & Economics

08 November 2017

Dear stakeholders,

**Proposal regarding the annual adjustment to the freight and charter operator
Schedule 8 benchmarks**

1. Schedule 8 provides Network Rail and operators with an incentive not to cause delay on the network, as well as compensating operators for some of the losses incurred as a result of delays that they do not cause. The regime is re-calibrated at each periodic review to ensure that, in the next control period, it continues (a) to provide incentives to Network Rail and operators to avoid causing delay and (b) to protect operators from the financial risk arising from delay caused by other parties.
2. In February 2017 we set up the Schedule 4 and 8 Re-calibration Working Group (hereafter: the Working Group) to agree the process and priorities for the PR18 re-calibration of these regimes. In the meeting of 28th April 2017, the Working Group discussed the annual adjustment to the freight and charter operator benchmarks. We were asked for guidance on whether this adjustment should be retained into CP6 and, if so, whether and how it should be re-calibrated.
3. We propose not to retain the annual adjustment to freight and charter operator Schedule 8 benchmarks in CP6. This letter sets out the rationale behind this proposal.

Background

4. The operator Schedule 8 regime (like the Network Rail regime) is a 'benchmarked' regime; if an operator causes more delay than its benchmark level, it pays Network Rail some multiple of the operator payment rate (determined by how far performance is from the benchmark). Conversely, if an operator causes less delay than the benchmark level, Network Rail pays the operator (according to the same formula).
5. In general, operator-caused delay will tend to affect more operators as traffic on the network increases. This means that, for a constant benchmark, if traffic increases then the Schedule 8 payments that a freight or charter operator makes will also increase. In CP5, freight and charter operators were protected from this effect by an annual adjustment to their benchmarks, which used the following formula:

$$\text{Benchmark}_{t+1} = \text{Benchmark}_t \times ((\text{Traffic growth} \times \text{Congestion factor}) + 1)$$

6. This adjustment means that when traffic increases or decreases on the network the freight and charter operator benchmarks increase or decrease, respectively.
7. The 'congestion factor' is a measure of the extent to which delay caused by operators results in more delay to third party trains as traffic on the network increases. It is fixed for each control period; for CP5 it is 1.044.

Options

8. There are three options for the annual adjustment to the freight and charter operator benchmarks for CP6:
 - A. Retain the adjustment with the current congestion factor of 1.044;
 - B. Retain the adjustment and re-calibrate the congestion factor; or
 - C. Remove the adjustment from the freight and charter operator benchmark.

Option A: Retain the adjustment with the current congestion factor of 1.044

9. This is the 'do nothing' option, the costs and benefits of the other two options have been assessed relative to this option.

Option B: Retain the adjustment and re-calibrate the congestion factor

10. The congestion factor is calculated using the capacity charge model. Re-calibrating the congestion factor would, therefore, require updating the capacity charge model for CP6, which would be difficult and costly, and would not otherwise be required given the decision to remove the capacity charge (see our [conclusions to the December 2016 charges and incentives consultation](#)). This looks to be disproportionate relative to the financial impacts of the adjustment factor.

Option C: Remove the adjustment from the freight and charter operator benchmark

11. From the perspective of Schedule 8 as an incentive regime, the rationale for the congestion factor is not particularly clear. For instance, the adjustment means that when traffic on the network increases, all else being equal, the total Schedule 8 liability for a freight or charter operator would remain the same, even as the total delay they cause increases. Removing the adjustment would thus send clearer signals to operators about the impact of the delay they cause on the network. It would also improve the simplicity of the regime and thereby lower administration costs.
12. Compared to retaining the current adjustment, removing the adjustment would have a financial impact on freight and charter operators. For context, we can estimate the scale

of this impact by looking at the effect of the adjustment in CP5. Over the first four years of CP5, the freight operator benchmark has increased 0.4% as a result of the adjustment. Working with Network Rail, we have estimated that if the freight operator benchmark had not been adjusted in CP5, then freight operators would have been between £0.91 and £1.57 worse off per 100 miles that they travelled.

13. It is worth noting, however, that the scale and direction of the financial impact of removing the adjustment in CP6 depends upon the difference between baseline and outturn traffic in CP6. For instance, if traffic were below the baseline in CP6 then removing the adjustment would leave operators better off than they would have been, had the adjustment been retained into CP6.

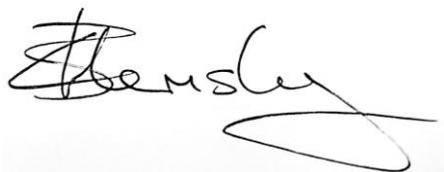
Proposal

14. **We propose to remove the annual adjustment of the freight and charter operator benchmarks.** Our recommendation is based on the benefits of simplification and the, albeit moderate, improvement in signals to operators. We will consider the financial impact on freight and charter operators of this decision in other areas of PR18 including the assessments of levels of mark-ups and any relevant caps.

Next steps

15. With respect to the on-going re-calibration of the freight and charter operator Schedule 8 benchmarks, this proposal does not change our position that they should be based on the expected performance of freight and charter operators in CP6.
16. If you believe that there are any issues relating to this decision that we have not considered please contact us (PR18.Schedules4and8@orr.gsi.gov.uk) by **Friday 5 January 2018**.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'Chris Hemsley', is written over a light grey rectangular background.

Chris Hemsley