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Dear Joanna

**Network Rail's response to ORR's PR18 consultation on Schedules 4 and 8**

This letter sets out Network Rail's response to ORR's consultation "PR18 Reviews of Schedules 4 and 8 of track access contracts", issued on 13 November 2015. The main body of this letter discusses the RDG Review of Charges work in this area and sets out some additional, high-level Network Rail points in addition to the RDG work. The annexes to this letter contain the relevant ideal features of the regime, as identified through the RDG Review of Charges project. We then augment this with some additional, detailed Network Rail comments.

The remainder of this letter is structured as follows:

- Summary
- The RDG Review of Charges
- Additional high-level Network Rail comments on Schedules 4 and 8
- Suggested next steps
- Annex A – Network Rail's response to detailed aspects of Schedule 4
- Annex B – Network Rail's response to detailed aspects of Schedule 8

**Summary**

Schedules 4 and 8 matter. Under any industry arrangement for CP6, there will need to be a possessions and performance regime. The current regimes are designed to hold operators financially neutral to the long term effects on their revenue[1] associated with different levels of planned and unplanned disruption, principally through a formulaic, pre-determined mechanism. This maximises value for the tax payer by maintaining franchise value (and the values of open access, freight and charter operators' businesses) at minimal transaction costs.

The regimes create significant financial flows between Network Rail and train operators. In 2014/15, net payments of over £100m were made from Network Rail to operators through Schedule 8. In the same year, £200m of compensation was paid from Network Rail to operators for taking possession of the network (through Schedule 4), which broadly matched Network Rail's ACS income.

[1] The long term revenue effect reflects operators' revenue losses as a result of passengers who have been deterred from using rail for future journeys, due to the lateness they experienced. Currently, the compensation is based on changes in passenger behaviours which last approximately 3 – 4 years after the original incident (based on the latest evidence from the PDFH). Similar assumptions are adopted in the freight regime.

In the context of these financial flows, the Schedule 8 regime in particular has come under significant public scrutiny in recent years. It is, therefore, especially important that the regimes are appropriate, supported by a robust evidence-base.

Despite these large financial flows, it is important that we do not forget that the primary purpose of the railway is to run trains for the benefit of users and tax-payers. In considering potential changes to Schedules 4 and 8, we should not lose sight of this. For example, we must recognise that in order to achieve this purpose, Network Rail needs sufficient access to maintain and renew the network.

We have summarised the key points from our response, below.

1. ORR should build on the RDG Review of Charges work as much as possible. The industry has put considerable time and effort into this work, and Network Rail would be reluctant to duplicate this by going back over what has already been discussed.
2. In its consultation, ORR recognises the strong links between the structure of charges and Schedules 4 and 8. However, it is not clear how these two workstreams will be joined up in PR18, given that they are currently being dealt with separately. We are strongly of the view that these areas of work should be considered together, or at the very least, the Capacity Charge should be considered alongside Schedule 8.
3. The industry needs greater clarity of the purpose of Schedules 4 and 8. We should not discuss the detail of the regimes until we have this clarity.
4. The complexity in the current regimes means that they have limited incentive effects.
5. The performance regime should encourage joint industry working, especially in terms of mitigating reactionary delay. This is a shortcoming of the current regime, and should be addressed for CP6.
6. The Schedule 8 payment rates must be set at the right level, otherwise operators and Network Rail face perverse incentives. We believe that some of the current payment rates may be too high (e.g. for London commuter services), and therefore will undertake work to establish better evidence for this in PR18.
7. For both regimes, we should attempt to create greater alignment with:
    a. Other performance mechanisms (e.g. franchise agreements)
    b. Other charges/incentives within the regulatory framework
8. There may be scope to absorb the additional Schedule 8 liability resulting from increased traffic on the network directly into Schedule 8. This could mean that the Capacity Charge would no longer be needed.

These comments, and ORR's review of Schedules 4 and 8 more generally, should be considered in the context of DfT's review of the current regulatory regime for the railways[2], where we will be arguing that ORR needs to do more to align incentives between Network Rail and train operators.

**The RDG Review of Charges**

RDG's Review of Charges project started in early 2014 and sought to review, and develop industry views on, the current charges and incentives regime. The purpose of this was to allow the industry to constructively inform PR18 and future reviews. Network Rail and operators have been the main

[2] Available at: https://www.gov.uk/government/consultations/rail-regulation-call-for-evidence

participants in this project, with input from Government/funders where appropriate. The project identified that the Capacity Charge, and the possessions and performance regimes were considered priority areas for development by the industry. It was felt that these areas displayed the largest misalignment with the RDG Vision[3].

Network Rail is fully supportive of the outputs of this work, and welcomes the links in ORR's letter to the project. We would like to reiterate the points that the industry agreed each regime should achieve[4]. These are shown below.

| The possessions regime should: | The performance regime should: |
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| Compensate operators for the financial impacts of planned possessions | Be coherent and aligned at every stage from end-users to funders |
| Be a liquidated sums regime, except for long possessions | Reflect end-user needs |
| Be financially neutral if possession activity is carried out efficiently | Encourage joint industry working to optimise whole-industry performance |
| Incentivise the industry to minimise the impact of possessions on end-users | Facilitate trade-offs between performance, traffic volumes, and cost |
| Facilitate the efficient use of possessions by all parties | Facilitate accurate and efficient attribution of the root causes of delays and cancellations |
| Incentivise operators to provide Network Rail with the access it requires to deliver engineering works | Be the sole remedy |
| Take account of the financial impact on all industry parties in taking possessions | Take account of the increased likelihood of delay of running an additional train on the network |
| Be sufficiently flexible to respond to unexpected end-user demand | Be effective at all levels of performance |
| | Be a liquidated sums compensation regime |

Network Rail considers that ORR should build on this work in its review of Schedules 4 and 8, rather than duplicate work already done.

**Additional high-level Network Rail comments on Schedules 4 and 8**

This section sets out Network Rail's high-level comments on Schedules 4 and 8. These comments are in addition to those provided through the RDG Review of Charges work.

*Safety*

In considering changes to Schedules 4 and 8, we should assess the extent to which each change improves safety.

*Engagement with industry*

We welcome ORR's early engagement on Schedules 4 and 8. These regimes are both very important to the industry, as identified through the RDG Review of Charges work. This early engagement should provide the best opportunity to address the current shortcomings, allowing time for more detailed work to be considered.

ORR's workshop on the 27th November was useful for industry parties to hear others' views on the regimes. However, we were disappointed that the workshops for the freight and passenger regimes

[3] Available at: http://www.raildeliverygroup.com/files/Publications/2014-12_rdg_review_of_charges_phase_1_vision.pdf
[4] Full report available at: http://www.raildeliverygroup.com/files/Publications/2015-05_rdg_roc_assessment_of_current_regime.pdf

were separated. At this early stage of the periodic review, both regimes should be considered together, as we would expect them to have a common purpose and key features.

*Level of detail*

The annexes to ORR's letter discuss different aspects of the regimes which ORR has asked stakeholders to comment on. These are quite detailed and, at this early stage of the review of Schedules 4 and 8, we consider that a better approach would be to identify what the industry wants the regimes to achieve (i.e. the purpose). Once this has been established, the review could then consider how each of these aspects of the regimes helps to achieve the purpose, and what could be changed to improve this.

This approach would be consistent with the industry view expressed as part of the RDG Review of Charges project, that: *"The industry should have a broader and clearer understanding of the purpose and aim of the regime"*

*The purpose of the regimes*

As noted above, we believe that a good approach to the review of Schedules 4 and 8 would be to, first, establish the desired purposes of both regimes. Once these have been decided on, we can then assess if or how the regimes need to change to achieve the purposes. Without this clarity, we cannot begin to assess the specific aspects of the current regimes.

Below, we state what we consider the purpose of each regime should be. In the annexes, we then explore the extent to which the current aspects of the Schedule 4 and 8 regimes achieve these purposes. However, it should be noted that if the purposes of the regimes are different from those suggested below, these assessments may no longer be appropriate.

**Network Rail's suggested purpose for the possessions regime:** a mechanism to ensure Network Rail is provided with reasonable access to the network in order to undertake maintenance, renewals and enhancements work. This should be facilitated through a compensation arrangement which protects operators' businesses from the effects of reduced network access. In so doing, it should facilitate the efficient use of possessions by all industry parties. The regime should achieve this with minimal transactions costs.

**Network Rail's suggested purpose for the performance regime:** a compensation regime to protect train operators' businesses from the financial effects of unplanned disruption which is not their fault. The regime should achieve this with minimal transaction costs.

In developing the purposes of Schedules 4 and 8, we should be mindful of possible future changes to the railway. For example, Digital Railway will bring about significant changes, including to the interfaces between Network Rail and operators.

*Incentive effects of the regimes*

The complexity of both of the regimes, and in particular the Schedule 8 regime for passenger operators, can make them difficult to understand. This complexity undermines the incentive effects, as there is no easy way for front line staff to immediately understand the effect of their actions on

Schedule 8 payments. One way to strengthen the incentive effects of Schedule 8 could be to create a more simple regime, which ensures that the Schedule 8 effects of 'on the day' decisions can be immediately understood.

In addition to this, there are many performance mechanisms, other than Schedule 8, that the industry is exposed to. We recommend that ORR is mindful of these, and wherever possible seeks to create consistency with Schedule 8. For example, franchise agreements contain a performance regime which can often contain different (and potentially conflicting) targets and metrics compared with Schedule 8. These other performance mechanisms may have stronger incentive effects than Schedule 8.

This approach would align to the industry view expressed as part of the RDG Review of Charges, that: *"The regime should align with: other parts of the industry's regulatory and contractual framework; public transport policies; and the needs of customers (passengers and freight users)"*

As an industry, we should attempt to better understand the 'on the ground' effectiveness of the regimes. This could involve an assessment of the extent to which the regimes influence the 'right' behaviours by Network Rail and other industry parties.

**Suggested next steps**

Once ORR has taken note of the feedback from its consultation, we believe that some sensible next steps may be as follows:

1. ORR should continue its early engagement with the industry on Schedules 4 and 8. One way to do this could be to set up an industry working group early in 2016, to address the issues raised in stakeholders' responses to ORR's consultation. Initially, the working group should consider the purpose of each regime. Network Rail would welcome continued and early engagement of this sort.
2. It would be very helpful if ORR could provide greater clarity on how it will take account of the RDG Review of Charges. If ORR does not agree with any aspect of the work, or decides not to take some of it on board, ORR should clearly articulate its reasons.
3. Network Rail would welcome some indication of timescales for ORR's review of Schedules 4 and 8. For example, this could be similar to the letter that ORR sent to the RDG Contractual and Regulatory Reform Working Group about its review of the structure of charges[5]. This could include some explanation of how this review will fit in with the rest of the periodic review process, especially the review of the structure of charges.

If you would like to discuss the content of this letter in more detail, please contact myself or my colleague Caitlin Scarlett.

Yours sincerely

Peter Swattridge

[5] Available at: http://orr.gov.uk/__data/assets/pdf_file/0003/15375/rdg-structure-of-charges-letter-2014-12-05.pdf

## ANNEX A – NETWORK RAIL'S RESPONSE TO DETAILED ASPECTS OF SCHEDULE 4

For each aspect of Schedule 4, identified in the ORR consultation document, we provide the relevant ideal features of the regime as identified through the RDG Review of Charges project. Network Rail is strongly supportive of each of these features. We then augment this with some additional, Network Rail comments.

Our key comments on the specific aspects of Schedule 4 are summarised, below.

1. Before we begin to discuss the detail of the regime, we should agree on the purpose of the possessions regime for CP6. We have provided a suggested purpose below, and would welcome further discussion on this with ORR and the industry.
2. The level of compensation provided to operators (including the notification factors in the passenger regime) should be based on robust evidence, and should be transparent to all industry parties. We understand that PDFC has recently undertaken some work in this area, which we should review as an industry.
3. The interaction between Schedules 4 and 8 often encourages perverse behaviours by operators and Network Rail in relation to 'snow days'. This is not in the best interests of end-users, and we would welcome an open discussion about how to address this issue as part of PR18.

| Aspect of Schedule 4 | Network Rail comment |
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| The purpose of Schedule 4 | Network Rail considers that the possessions regime should be a mechanism to ensure Network Rail is provided with reasonable access to the network in order to undertake maintenance, renewals and enhancements work. This should be facilitated through a compensation arrangement which protects operators' businesses from the effects of reduced network access. In so doing, it should facilitate the efficient use of possessions by all industry parties. The regime should achieve this with minimal transactions costs.<br><br>The regime should help Network Rail and operator decision-making, such that possessions minimise whole-industry costs. These costs will vary depending on the access pattern. For example, under the current regime, shorter possessions may be 'cheaper' in terms of Schedule 4 compensation (e.g. the possessions could be taken overnight), but will require more access slots to do the same work compared to a longer possession. Multiple access slots are likely to increase the cost of the work, due to the increased number of 'take-up' and 'hand-back' periods. A balance should be struck between minimising disruption for end-users, and minimising the costs of the work (i.e. such that whole-industry costs are minimised). It is important that this balance is recognised in Network Rail's funding for Schedule 4.<br><br>One way to minimise whole-industry costs could be to provide Network Rail with signals as to the financial impact of possessions on operators. Compensation needs to be accurately calibrated, to provide the correct signals to Network Rail. The industry should have an open |

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| | and honest discussion about what the compensation should be calibrated to recover, and this should be clearly articulated.<br><br>Through the RDG work, the industry agreed that the liquidated sums nature of Schedule 4 should be retained in any future performance regime. In order to achieve the above purpose with minimal transaction costs, the regime should continue to be liquidated sums. It is possible that liquidated sums may not be appropriate for larger possessions, and so the regime should allow for bespoke arrangements in these situations.<br><br>In further developing the purpose of the possessions regime, it is important that we are realistic about the limits of what the regime can achieve. For example, it is widely believed that the current Schedule 4 regime does not significantly impact on possessions planning, since other planning mechanisms exist which may provide stronger incentives (e.g. the Engineering Access Statement and the Industry Access Programme). In developing the possessions regime for CP6, we should be aware of these other mechanisms, and seek to align with them wherever possible. As a minimum, the regime should not go against these other planning processes. |
| The level of compensation | **The compensation provided in the Schedule 4 regime is largely consistent with Network Rail's suggested purpose. The level of compensation should be based on robust evidence, and be calculated in a transparent way.**<br><br>**RDG features - the regime should:**<br>• Compensate operators for the financial impacts of planned possessions;<br>• Be a liquidated sums regime, except for long possessions; and<br>• Take account of the financial impact on all industry parties in taking possessions.<br><br>The industry highlighted that many of these features are already achieved by the current regime (e.g. the liquidated sums nature, and bespoke arrangements for larger possessions).<br><br>**Additional Network Rail comments:**<br>We consider that it is really important that the level of compensation in the Schedule 4 regime is correct. This is because incorrect levels of compensation could create distorted incentives for Network Rail, in terms of 'costing up' its possessions activities.<br><br>In the current passenger regime, the revenue compensation in Schedule 4 is based on the Network Rail payment rates in Schedule 8, reduced to reflect the early notification of disruption that Network Rail provides. We believe the compensation provided through the Schedule 4 regime should be evidence-based. This would involve examining whether the link between compensation in Schedules 4 and 8 is still appropriate. The Passenger Demand Forecasting Council (PDFC) has already commissioned consultants to examine the relationship |

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| | between planned disruption and passenger demand. We should review this work, and see whether it supports the current level of Schedule 4 compensation. We can then decide, as an industry, if more work is needed in this area. Similarly, we should seek to establish better evidence to inform compensation for possessions for freight operators. All evidence, and subsequent calculations of compensation levels, should be available for the whole industry to review and scrutinise. |
| Notification discount factors | **Notification discount factors are intended to better reflect operators' costs of planned disruption. However, the thresholds and levels of discount should reflect latest available evidence.**<br><br>**RDG features - the regime should:**<br>• Incentivise the industry to minimise the impact of possessions on end-users; and<br>• Incentivise operators to provide Network Rail with the access it requires to deliver engineering works.<br><br>In addition to the above, the industry considers that the current Schedule 4 regime facilitates the early notice of possessions, and this feature should be retained for CP6.<br><br>**Additional Network Rail comments:**<br>The current time thresholds for the notification discount factors in the passenger regime were designed to be reflective of when timetables are announced, and have not been updated for some time. It seems likely that passengers' behaviours may have changed over time - the increased use of smart phones and availability of internet 'on the move' may mean that published timetables have less significance than previously thought.<br><br>We consider that there would be merit in investigating what the time thresholds for the notification discount factors should be. This should be based on up-to-date empirical evidence of actual passenger behaviours. If this is not possible, then other sources should be used to inform an appropriate threshold (for example, using data showing how far in advance passengers purchase tickets). Whilst the notification discount factors have been updated recently, we consider that there would be merit in reviewing these, alongside the time thresholds, to ensure the levels of discount are appropriate and based on latest available evidence.<br><br>It may be appropriate for the notification factors and thresholds to continue to vary depending on the market if this is consistent with the evidence. For example, it can be expected that long distance passengers would book tickets further ahead that commuter passengers, and so would be more aware of future disruption at an earlier stage. |
| The ACS | **In attempting to ensure that Network Rail is financially neutral through Schedule 4 (if possessions are used efficiently), the ACS is aligned to Network Rail's suggested purpose. However, improvements to the calculation methodology should be explored.** |

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| | **RDG features - the regime should:**<br>• Be financially neutral if possession activity is carried out efficiently.<br><br>**Additional Network Rail comments:**<br>Network Rail considers that there could be merit in exploring new ways for calculating the overall level of ACS, and the allocation of this to operators. Furthermore, it should also be noted that if there were changes to the level of compensation received by freight operators, the industry would have to explore options for the transparent funding of this. |
| Sustained planned disruption (SPD) | **The SPD thresholds should be set at an appropriate level, capturing only the most disruptive possessions.**<br><br>**RDG features - the regime should:**<br>• Be a liquidated sums regime, except for long possessions.<br><br>SPD provides a mechanism for passenger operators to recover the financial impact of larger possessions. To this end, it is consistent with the above RDG feature.<br><br>**Additional Network Rail comments:**<br>In developing the SPD mechanism for CP6, we should ensure that the threshold is set at an appropriate level, which captures only possessions for which formulaic compensation is significantly unrepresentative of actual costs and losses. |
| Interaction with regulated outputs | **RDG features - the regime should:**<br>• Be coherent and aligned at every stage from end-users to funders;<br>• Reflect end-user needs;<br>• Facilitate the efficient use of possessions by all parties;<br>• Incentivise operators to provide Network Rail with the access it required to deliver engineering works; and<br>• Facilitate the delivery of industry outputs and aims over both the short and long term.<br><br>It was widely felt by the industry that the possessions regime does not adequately reflect the impact on the end-user, since payments are based on the number of trains disrupted rather than the effects on passengers and freight users. Any changes to the metrics in the possessions regime should be linked to what end-users value, and should reflect what the possessions regime is seeking to achieve. |

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| | **Additional Network Rail comments:**<br>In ORR's consultation, it notes the possession disruption index (PDI) and its interaction with Schedule 4. Whilst Schedule 4 payments to passenger operators are used in calculating the passenger metric (PDI-P) during CP5, there are no Schedule 4 inputs into the freight metric (PDI-F). Furthermore, Network Rail's targets for PDI-P and PDI-F are not linked to assumed levels of possessions for Schedule 4. There are a number of reasons for this:<br>1. Schedule 4 estimates are based on maintenance and renewals activity only, whereas the PDI targets also include disruption due to enhancements.<br>2. PDI-P and PDI-F targets are calculated based on the level of disruption for 2007/08 and projected CP5 spend on track maintenance and enhancements. Schedule 4 estimates are based on traffic and Schedule 4 cost data from 2011/12, multiplied by planned CP5 activity volumes[6].<br><br>In addition to the interaction with regulated outputs, a key factor in Network Rail being provided with access to the network is the level of operator cooperation (i.e. the extent to which operators agree to Network Rail's possessions plans). For franchised passenger operators, it is important that their franchise agreements allow for Network Rail to take possession of the network, without penalising the operator for this. |
| Perverse incentives and unintended consequences | **RDG features - the regime should:**<br>• First do not harm;<br>• Work in both expanding and shrinking markets;<br>• Not be overly sensitive to relatively small changes in industry outputs; and<br>• Be sufficiently flexible to respond to unexpected end-user demand.<br><br>**Additional Network Rail comments:**<br>Typically, Network Rail plans engineering work and subsequent possessions plans well in advance of the actual date that the work will take place. This allows operators to provide customers with notice of the upcoming disruption, and allows operators a greater planning horizon to arrange alternative transport arrangements (e.g. replacement buses for passengers).<br><br>Sometimes, unexpectedly high levels of demand mean that Network Rail's planned possessions are no longer convenient for operators (for example, for major events such as sporting events, which are often planned just months in advance). In this case, the right thing to do could be to rearrange the engineering work (and associated possession), such that train services can run to accommodate the demand. However, the Schedule 4 regime is not currently sufficiently flexible to allow Network Rail to respond in this way without being financially penalised. |

[6] An overlay was applied to the resulting Schedule 4 costs for passenger operators, to reflect the remaining improvements necessary to achieve the CP4 PDI-P.

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| | Under the current regime, Network Rail may have to make a number of payments associated with changing a possession at late notice:<br>• Compensation to operators if it changes the possession with less than 12 weeks' notice. Operators may claim back the costs that they have already committed (for example, for running replacement bus services); and<br>• Compensation to operators for the rearranged possession. This is likely to exceed the compensation that was originally payable, because the rearranged possession will probably be planned with less notice provided to the operator (and hence Network Rail would not benefit from the early notification discount).<br><br>These payments can act as a disincentive on Network Rail to alter its possession plan, despite it being the right thing to do to minimise the impact on passengers and to recognise operator's preferences for moving possessions. We believe that it should be possible to remove this disincentive from the regime, through minor amendments to the Track Access Contracts. |
| Other aspects of the regime | *Snow days*<br>There is some evidence to suggest that the current performance and possessions regimes may not appropriately align operator and Network Rail incentives in the case of severe weather ('snow days'). It has been contended that neither Network Rail nor the train operator want to be the first to declare a reduced timetable due to a severe weather day as that party would then become liable for the associated Schedule 4 cost. This reluctance to be the first to call off running the full timetabled service can result in a 'stand-off' situation - if this happens, both parties will become liable for Schedule 8 payments for the resulting delays on the day.<br><br>This can then translate into the full timetable being published for the 'snow day', which does not reflect a realistic level of service. Passengers will then make travel plans in good faith based on an unrealistic timetable. This can then lead to overcrowding at stations (a potential safety issue) as passengers turn up expecting trains to run, which are unable to do so. This causes considerable angst to passengers and shows the industry in a bad light, leading to reputational damage.<br><br>As part of ORR's review of Schedules 4 and 8, we would welcome further consideration about how to improve the regimes in relation to snow days. As a minimum, we believe that different Network Rail payment rates should apply on snow days. This is because the payment rates are based on evidence set out in the Passenger Demand Forecasting Handbook (PDFH). However, PDFH explicitly states that delays caused by severe weather do not have the same scale of impact on customer behaviours as other delays.<br><br>We would also welcome further discussion about other interactions between Schedules 4 and 8 which create perverse behaviours. |

**ANNEX B – NETWORK RAIL'S RESPONSE TO DETAILED ASPECTS OF SCHEDULE 8**

For each aspect of Schedule 8, identified in the ORR consultation document, we provide the relevant ideal features of the regime as identified through the RDG Review of Charges project. Network Rail is strongly supportive of each of these features. We then augment this with some additional, Network Rail comments.

Our key comments on these specific aspects of Schedule 8 are summarised, below.

1. Before we begin to discuss the detail of the regime, we should agree on the purpose of the performance regime for CP6. We have provided a suggested purpose below, and would welcome further discussion on this with ORR and the industry.
2. The level of compensation provided to operators should be based on robust evidence, and should be transparent to all industry parties. We have commissioned consultants to examine the relationship between operator revenue and lateness for London commuter services, and will be sharing the results of this analysis with the industry.
3. The current regime does not place financial incentives on passenger operators to mitigate reactionary delay from their own incidents. This is because passenger operators are exposed to the modelled impact of their own delay, and so do not receive the benefits of a better than expected recovery from their incident.
4. We should consider alternatives to the Capacity Charge in industry discussions about Schedule 8.

| Aspect of Schedule 8 | Network Rail comment |
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| The purpose of Schedule 8 | Network Rail considers that the performance regime should be a compensation regime to protect train operators' businesses from the financial effects of unplanned disruption which is not their fault. The regime should achieve this with minimal transactions costs. The regime should also allow for trade-offs between performance, traffic and costs, and facilitate accurate delay attribution.<br><br>In further developing the purpose of the performance regime, it is important that we are realistic about the limits of what the regime can achieve. For example, and as discussed later in this annex, there are other mechanisms within the industry which may provide more significant, and potentially different, incentives.<br><br>Through the RDG Review of Charges project, the industry agreed that the liquidated sums nature of Schedule 8 should be maintained in any future performance regime. In order to achieve the purpose with minimal transaction costs, the regime should continue to be liquidated sums.<br><br>However, there was no consensus about what sort of compensation could be included in the regime, for example if it is appropriate for |

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| | compensation to include direct costs such as paying for passenger refunds 'on the day'. The industry should further discuss this, and following these discussions we should clearly articulate the conclusions. Network Rail considers that the compensation should not include an element to account for the socioeconomic costs of delayed trains, as was discussed at ORR's workshop. Not only would this be extremely difficult and resource-intensive to calculate due to localised and seasonal effects, it would also be inappropriate to provide this compensation to operators as they do not incur the socioeconomic impacts of unplanned disruption. |
| Network Rail payment rates | **This aspect of Schedule 8 is consistent with Network Rail's suggested purpose, but the payment rates must be evidence-based and transparent.**<br><br>**RDG features - the regime should:**<br>• Be a liquidated sums compensation regime;<br>• Be effective at all levels of performance; and<br>• Be the sole remedy.<br><br>The industry highlighted that the liquidated sums nature of the current regime, and it being effective at all levels of performance, should be retained for any future performance regime.<br><br>There was some discussion about whether or not the Network Rail payment rates should include end-user compensation. This was especially relevant for passenger operators. No consensus was reached on this subject as part of the RDG work. ORR may wish to consider this in greater detail, in its review of the Schedule 8 regime.<br><br>**Additional Network Rail comments:**<br>Network Rail considers that it is really important that the Network Rail payment rates in the Schedule 8 regime are 'correct' (i.e. align well to the purpose of Schedule 8) and are calculated in a transparent way. The regime has already come under significant public scrutiny in recent years, primarily due to the large financial flows created by the regime, as illustrated by the quotes below. As an industry, it is therefore especially important that we invest effort into creating a robust, defendable evidence-base, and using this to inform the level of compensation paid to operators.<br><br>*"Train operators cash in on delays" – Telegraph*<br>*"First Great Western handed nearly £20m in compensation for delays to services" – getreading.co.uk*<br><br>If the payment rates are set at the wrong level, operators and Network Rail may face perverse incentives. For example, if the payment rates |

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| | are too high, operators may not be overly challenging of Network Rail's performance, as there would not be a financial incentive to do so. This also increases the financial risk of the regime for all parties. Network Rail believes that some of the payment rates in the passenger regime may currently be too high, especially for London commuter services. We have commissioned consultants to undertake a study into this, for London commuter services only, in which they will be attempting to directly estimate the impact of lateness on operators' revenues. We will share the results of this analysis with the industry.<br><br>The calculation of the Network Rail payment rates should be transparent, allowing all parties to review the calculations and the input data. Given the large financial flows that result from Schedule 8, we consider that it is vital that all parties to the regime understand the basis of the payments. In addition, having a greater number of parties review the calculations will help to reduce the risk of errors occurring.<br><br>The Network Rail payment rates currently attempt to reflect the full, predicted, future value of lost operator revenue. Given that much of this revenue loss is not felt immediately, we consider that it may be appropriate to consider whether or not to discount the payment rates for the time value of money, reflecting the fact that operators are receiving a fixed amount almost immediately after the disruption, in lieu of a potential amount of revenue at some time in the future. |
| Network Rail benchmarks | **The Network Rail benchmarks must be set at an appropriate level in order to create the correct incentives for Network Rail.**<br><br>**RDG features:**<br>• None<br><br>**Additional Network Rail comments:**<br>The Network Rail benchmarks in the passenger Schedule 8 regime for CP5 were calibrated to align with Network Rail's regulatory targets. NTF is currently undertaking some work to examine possible performance metrics for regulatory targets in CP6. We should ensure that the Schedule 8 regime is joined up with this work, where possible. However, we should be mindful that sufficient data may not be available to accurately calibrate the CP6 Schedule 8 regime if the metrics change – this would depend on the conclusion of the final metric(s) in the NTF work, and ORR's subsequent determination.<br><br>Similarly, Network Rail benchmarks in the freight regime should be based on metrics which are comparable to, or translatable into, other freight performance targets (i.e. FDM). |
| Sustained poor performance (SPP) | **SPP is not consistent with Network Rail's suggested purpose. It can create significant transaction costs for both parties involved, and undermines the liquidated sums nature of Schedule 8.** |

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| | **RDG features - the regime should:**<br>• Be the sole remedy;<br>• Be effective at all levels of performance; and<br>• Be a liquidated sums compensation regime.<br><br>SPP contradicts all of these desired features. It allows passenger operators to make case-by-case claims against Network Rail when performance is 10% worse than target. This means that Schedule 8 is no longer the sole remedy. It also implies that Schedule 8 is not effective at all levels of performance, by providing a mechanism for passenger operators to claim for actual costs and losses below a certain level of performance. Furthermore, it undermines the liquidated sums nature of Schedule 8.<br><br>**Additional Network Rail comments:**<br>Due to the contradiction with the RDG features, we consider that there is a strong case for reforming the SPP arrangements for CP6. We would welcome discussions with ORR and the rest of the industry on this.<br><br>Currently, roughly half of all passenger operators are in SPP. This figure appears to be too high (despite Network Rail missing its overall performance targets) and suggests that if no other reforms are made to SPP, the threshold should at least be adjusted to a more realistic level. Network Rail commissioned consultants Steer Davies Gleave (SDG) to provide analysis to inform an appropriate SPP threshold during PR13. SDG concluded that an appropriate threshold would be 30%. We believe that this analysis should be revisited in PR18. In addition to this analysis, the Reliability Review for the update to the Passenger Demand Forecasting Handbook (PDFH 5.1) states that the revised GJT elasticities and late time multipliers “are probably robust up to about 30% change”. Therefore, we can conclude that formulaic compensation for disruption should be suitable up to this level. This evidence should be considered when examining the SPP mechanism in PR18.<br><br>We would also be content to explore the option of providing ‘enhanced’ levels of formulaic compensation for performance significantly below target (i.e. retaining the liquidated sums feature of Schedule 8). This would avoid the current lengthy and time-consuming process for SPP claims. Any enhanced formulaic compensation would, of course, need to be evidence-based. |
| Operator payment rates and the star model | **Operator payment rates and the star model are consistent with Network Rail’s suggested purpose.**<br><br>**RDG features - the regime should:**<br>• Be a liquidated sums compensation regime.<br><br>Furthermore, the industry identified the star model as being a feature of Schedule 8 that should be retained. |

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| | **Additional Network Rail comments:**<br>Network Rail is strongly supportive of the star model in Schedule 8. Without it, there is a risk that there could be multiple contractual arrangements between each operator in order to provide compensation for delays. This would be costly for the industry, and add to the complexity of the performance regime.<br><br>However, in retaining this feature it is important that the calibration of the star model is accurate. Some initial calculations suggest that the star model has started to drift away from neutrality since the start of CP5. This has resulted in Network Rail paying out more for operator delays than it receives through Schedule 8 to do so (after accounting for the impacts of the TOC payment rate error[7]).<br><br>One reason for the non-neutrality in the passenger operator regime is because TOCs pay for TOC-on-Self (ToS) lateness. The payment rates are calculated to account for the **estimated impact** of ToS lateness on third party operators, and so are designed to be equal to the amount that Network Rail pays out for this delay (after accounting for benchmarks). However, in general, incidents of ToS lateness now appear to have a greater impact on third party operators, which Network Rail must pay for. This could mean that passenger operators face limited incentives, through the current Schedule 8 regime, to mitigate reactionary delay as a result of their own incidents. We discuss this point in the “perverse incentives and unintended consequences” section. This is not a problem in the freight regime or charter regimes, as these operators pay for actual delay minutes caused to third party operators. |
| Operator benchmarks | **Operator benchmarks must be set at an appropriate level in order to set the correct incentives for operators to manage their own delays.**<br><br>**RDG features:**<br>• None<br><br>**Additional Network Rail comments:**<br>As noted in the section on Network Rail benchmarks, NTF is currently undertaking some work to look at possible performance metrics for regulatory targets in CP6, for passenger operators. We should ensure that, were possible, the Schedule 8 regime is joined up to this work. |

[7] Identified by ORR in 2015.

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| Treatment of cancellations | **RDG features:**<br>• None<br><br>**Additional Network Rail comments:**<br>In the freight and charter regimes, cancellations are treated separately from delays. Network Rail pays compensation for cancellations of all freight and charter services, instead of paying against a benchmark, implying that an 'efficient' level of cancellations for these operators is 0. This is inconsistent with the treatment of delays, and also inconsistent with the treatment of cancellations in the passenger regime. We believe that there could be merit in treating cancellations for freight and charter operators consistently with the rest of the regime, for example through the introduction of a cancellation benchmark.<br><br>In the passenger regime, TOCs pay Network Rail for their cancellations of their own services. The amount they pay Network Rail is determined by the operator payment rates, and is designed to be equivalent to Network Rail's expected Schedule 8 liability to other operators as a result of this cancellation. However, in some circumstances TOC cancellations have no impact on other operators (e.g. if they occur before the train enters service). As an industry, we should explore if the current arrangements are appropriate. |
| Liability caps | **Liability caps are consistent with Network Rail's suggested purpose. They protect the values of charter and freight businesses by limiting their payments as a result of individual incidents, or annual payments. They also hold Network Rail financially neutral, on expectation.**<br><br>**RDG features:**<br>• None<br><br>**Additional Network Rail comments:**<br>Liability caps allow freight and charter operators to plan their businesses more effectively, by providing certainty as to the maximum amount that they will have to pay out annually, or for each incident, through Schedule 8. Network Rail is held financially neutral, on expectation, through the ACS income received in exchange for incident liability caps. Liability caps are not a feature of the current passenger operator regime, since passenger operators only pay for TOC-on-Self lateness (see earlier section on the star model).<br><br>We consider that liability caps should be retained for CP6, but the evidence underpinning the level of the cap and the associated ACS (for incident caps) should be reviewed to ensure that Network Rail remains financially neutral. |

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| Interaction with regulated outputs and franchise obligations | **The lack of alignment with Schedule 8, regulatory targets and franchise obligations can often prevent a joint industry approach to improving performance.**<br><br>**RDG features - the regime should:**<br>• Be coherent and aligned at every stage from end-users to funders;<br>• Reflect end-user needs;<br>• Encourage joint industry working to optimise whole-industry performance;<br>• Facilitate trade-offs between performance, traffic volumes, and cost; and<br>• Facilitate the delivery of industry outputs and aims over both the short and long term.<br><br>It was widely felt by the industry that the metrics used for performance are misaligned, and that these metrics do not focus on the end-user since payments are based on the number of trains disrupted rather than the effects on passengers and freight users. Any changes to the metrics in the performance regime should be linked to what end-users value, and should reflect what the performance regime is seeking to achieve.<br><br>**Additional Network Rail comments:**<br>The current Network Rail benchmarks in the passenger regime are calibrated to be equivalent to Network Rail's regulatory performance targets. The differences in metrics can mean that they drift apart over time (the Network Rail benchmarks are set using Average Minutes Lateness whereas regulatory targets are based on PPM and CaSL). NTF is currently undertaking some work to look at possible performance metrics for regulatory targets in CP6. We should ensure that the Schedule 8 regime is aligned to this work, where possible.<br><br>Franchised passenger operators have performance targets set by DfT in their franchise/concession agreements. However, there is no attempt to link Schedule 8 with these performance targets. This leads to a misalignment in both the level of the target, and the metric used for the target, in each regime. The greatest problem of misalignment occurs either where the services are less commercial (i.e. some "regional" markets) or where there is little choice for passengers (i.e. most "London and South East" markets). In these cases, TOC incentives are driven more by the franchise/concession agreement, which limits the incentive effects of Schedule 8. This can create problems for Network Rail in delivering its regulatory targets, as different industry parties are working towards different performance targets. For PR18, the industry should work together to create a greater incentive for the industry to achieve desired performance levels for CP6.<br><br>To improve this alignment, it is important that DfT is 'on-board' with any suggested changes. |

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| Perverse incentives and unintended consequences | **RDG features - the regime should:**<br>• Be effective at all levels of performance;<br>• Not be overly sensitive to relatively small changes in industry outputs;<br>• Encourage joint industry working to optimise whole-industry performance; and<br>• Facilitate accurate and efficient attribution of the root causes of delays and cancellations.<br><br>**Additional Network Rail comments:**<br>If Network Rail payment rates are set at an incorrect level, this will create perverse incentives for all parties. For example, if the payment rates were too high, then operators would be over-compensated for delays caused by Network Rail and third parties. This could mean that operators may not be overly challenging of Network Rail's performance, as there would not be a financial incentive to do so. Clearly, these are not the incentives that should be created through any performance regime. Therefore, it is very important to set payment rates at the right level, and base them on appropriate evidence. As noted previously, we have commissioned consultants to estimate the direct effects of lateness on operator revenue. We will share the results of this work with the industry.<br><br>The passenger operator Schedule 8 does not encourage joint working in terms of mitigating reactionary delay. There are a number of possible reasons for this:<br>1. The regime is designed to compensate operators in full for delays caused by Network Rail or third party operators. Therefore, delayed operators have no financial incentive, through Schedule 8, to mitigate reactionary delays resulting from the initial incident, as they will receive compensation which exactly offsets their revenue losses. In addition, if the operator committed resources to helping mitigate these delays, it would not be able to recover these through the regime, and could therefore be worse off as a result of trying to do the right thing.<br>As noted above, TOCs pay for TOC-on-Self (ToS) lateness. The payment rates are calculated to account for the **estimated impact** of ToS lateness on third party operators. However, this means that the TOC causing the initial incident faces no incentives through the Schedule 8 regime to minimise reactionary delays, affecting other operators, resulting from their initial delay. One way to create these incentives would be for TOCs to pay for TOC-on-Third Party lateness, as freight and charter operators do currently. |
| Other aspects of the regime | *<u>Complexity</u>*<br>The current Schedule 8 regime is complex (especially the passenger regime). This complexity can undermine the incentive effects of the regime, as there is no easy way for frontline staff to immediately understand the effect of their actions on Schedule 8 payments. One of the best ways to strengthen the incentive effects of Schedule 8 would be to create a more simple regime, which ensures that the effects of 'on the day' decisions can be immediately understood by all involved. We should consider how to improve the incentives created by the regime as part of PR18. |

*Delay attribution*
Under the current regime, disputes about delay attribution are common. The recent RDG work identified this, and suggested that this was due to industry parties seeking to minimise their Schedule 8 payments. This can often result in incorrect delay attribution. Resolving these disputes uses up a considerable amount of industry resources. For CP6, we should consider alternative, for example, independent delay attribution. This should only be pursued if it proves to be value for money when compared against the current arrangements (whereby Network Rail attributes delays).

*Capacity Charge*
**RDG features - the regime should:**

- Take account of the increased likelihood of delay of running an additional train on the network; and
- Facilitate trade-offs between performance, traffic volumes, and cost.

The RDG work also identified that the current regime does not enable sufficient industry understanding of the trade-offs between performance, traffic volumes, and costs.

**Additional Network Rail comments:**
The Capacity Charge exists to recover the additional Schedule 8 liability resulting from increased traffic on the network. There will always be a requirement to ensure that this additional Schedule 8 liability is neutralised, and this was agreed with the industry as part of RDG's Review of Charges. The Capacity Charge should therefore be considered as part of ORR's review of the Schedule 8 regime. We find it alarming that ORR is not considering the Capacity Charge as part of this consultation. In PR13, ORR took a similar approach which resulted in considerable industry angst and a very late decision regarding the Capacity Charge by ORR.

The current structure of the Capacity Charge creates a great deal of financial uncertainty for freight, charter and open access operators, and Network Rail. This is due to new arrangements that were introduced for CP5, whereby CP4-equivalent rates are paid on traffic below a given baseline, and the higher, CP5 rates are paid on all additional traffic. Due to limitations in the Track Access Billing System (TABS), this must be calculated by means of a year-end wash-up. It is this annual wash-up process which introduces uncertainty regarding the amount of Capacity Charge income that Network Rail receives, and the amounts of Capacity Charge that these operators must pay. This makes business-planning very difficult for all involved, and we strongly believe that this arrangement should be removed for CP6. It is for this reason that we believe that the Capacity Charge should be considered as a priority area for develop for PR18.

There are a number of options for improving the current arrangements, which could include reforming the current charging arrangements, or absorbing the Capacity Charge into Schedule 8 (e.g. through adjustments to Network Rail benchmarks). We would welcome further discussion on this for PR18.

*Snow days*
Please see the comments under the heading “Other aspects of the regime” for Schedule 4.