



Department for Transport

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Dear Joanna

ORR PR18 consultation on the industry's internal performance and possessions regimes

This letter is DfT's response to ORR's Periodic Review 2018 consultation on the possessions (Schedule 4) and performance (Schedule 8) regimes, which deal with compensation for delays and disruption on the rail network.

Although good by historical standards, the rail industry's performance on train punctuality is below where it should be. Network Rail and train operating companies appear to have halted the deterioration in performance of the last two to three years but there is some way to go to meet the 92.5% Public Performance Measure (PPM) target set for the end of Control Period 5. In particular, there are still significant concerns over performance on some routes around London and the South East, where the level of service is a very long way off what passengers rightly expect. The Rail Minister and DfT are working very closely with the rail industry to drive further progress. Ultimately, a railway with better operational performance is a key ingredient of the world-class railway to which we aspire.

While making changes to Schedules 4 and 8 is not the only answer, it is one of a range of levers that can improve the availability and punctuality of train services, to the benefit of passengers, freight customers and more broadly to support the UK's economic productivity.

DfT's interest

DfT's interest in Schedules 4 and 8 is as follows:

- at the level of principle, to ensure that industry parties are appropriately incentivised to minimise disruption, in order to:
 - improve journeys for passengers and freight customers
 - improve rail's financial performance and
 - support economic growth and productivity
- as funder and owner of Network Rail
- to put in place effective compensation regimes to ensure that prospective franchisees:
 - are not dissuaded from bidding in the first place
 - do not incorporate excessive risk premium into their bids for franchises
 - are not subsequently destabilised during the franchise
 - are not subject to perverse incentives that lead to poor outcomes for passengers and
 - are not overcompensated for the impacts of delay and disruption, particularly on commuter routes where demand is strongly inelastic, and at the end of the franchise term.

Where franchisees are in profit share arrangements and where DfT takes revenue risk, revenues from Schedule 4 and Schedule 8 also have a direct commercial impact on DfT.

DfT's views on Schedules 4 and 8

The Department believes that some form of compensation regime for delays and disruption to services is crucial in the current industry structure. Having a pre-determined formula to calculate compensation provides important certainty for the franchise and wider operator market. No regime will be able to operate perfectly in all circumstances, and given the benefits of maintaining stability, broadly speaking the Department favours keeping these regimes in place, though there are a number of changes to scope and design that should be considered. DfT notes the work carried out by the industry on these regimes, led by RDG in its Review of Charges, and believes that this provides a useful platform for ORR's work in PR18.

Links with passenger compensation

Schedule 8 aims to compensate operators for any loss of revenue resulting from delay and incentivise Network Rail to optimise its operational performance. However, the regime does not link directly to compensation paid out to passengers. The level of public understanding and trust of the regime is low, despite the fact that Schedule 8 is designed to drive the right outcomes. There is an expectation both of greater transparency of these financial arrangements and, rightly or wrongly, of a direct link to passenger compensation.

It is clearly important that passengers are appropriately compensated for disruption on the railway and DfT has therefore been working to improve compensation arrangements with a view to introducing them in new rail franchises. We are considering options on this at the moment. We are

also working with ORR on the Which? super-complaint, with a view to ensuring that there is better information about and take-up of passenger compensation when delay and disruption occur.

As ORR takes forward its Periodic Review, DfT would welcome early discussions to consider whether there should be a more direct link between Schedule 8 and passenger compensation, or whether improvements to passenger compensation should be handled through other processes. In doing so, it will be important to have regard both to putting the right incentives in place, and to creating a transparent system that inspires public trust.

Economic productivity and societal impacts

The Schedule 4 and 8 regimes do not currently reflect the loss of socioeconomic benefits resulting from delays and disruption. Consequently, there is a risk that Network Rail's actions at times of delay or disruption do not take account of these factors. DfT believes that ORR should consider whether or not changes should be made to the regimes to ensure that Network Rail is incentivised to this effect. We would be interested in engaging further in discussions on this point.

There are financial and presentational arguments against increasing the amount of money flowing through these regimes. Consideration would need to be given to whether train operators were involved in any such element of the regime. Further, given taxpayers would ultimately be funding any additional Network Rail payments in this area, and are the parties affected by the loss of socioeconomic benefits resulting from delay and disruption, any socioeconomic payments would need to flow back to taxpayers.

Implications for franchise change

Unless there were grandfathering arrangements, any changes to access charges or incentive regimes would require changes to be made to all existing Franchise Agreements and contracted franchise financial models. Due to the complexity of the charging structure, the change process is complex and incurs significant costs. The relatively simple PR13 change cost the Department around £2 million to implement, and TOCs and other procuring authorities will also have incurred significant implementation costs. In the event that there were material changes to the structure of charges or incentive regimes, these costs would be materially higher, and there would be significant scope for uncertainty, and risk of disputes with operators, about the outcome of the change.

For these reasons, DfT believes that there should only be change to the structure of any access charges or incentive regimes which affect current franchises where it can be demonstrated that the change will deliver a clear and substantial benefit. If changes will be difficult to implement, ORR could consider applying these from the franchise renewal date only.

Incentivising train operators to mitigate Network Rail delay

The Schedule 8 regime as currently constituted focuses on compensating train operators in full for lost revenues and does not in itself incentivise train operators to engage with Network Rail to mitigate the impact of delays caused by Network Rail, and minimise any reactionary delay from that. Specifically, there is a risk that full compensation could make TOCs indifferent to level of NR performance, from a Schedule 4 and 8 perspective. This is not a question about the rate of compensation, which is addressed under a separate heading below.

DfT notes that train operators have other incentives to improve performance. Nonetheless, greater alignment of incentives between train operators and Network Rail in respect of compensation arrangements could minimise operational performance delays to the benefit of passengers, freight users and taxpayers.

DfT is interested in considering mechanisms that do not fully compensate TOCs, to generate the financial incentives for TOCs to work with NR to reduce delays. Such a mechanism could be constructed without reducing incentives on NR and could be achieved through the design of future Franchise Agreements. For example, a Franchise Agreement could define that an operator would not retain all of the revenue received through schedule 4 or 8, which by transferring some risk to the operator for Network Rail's outturn performance and for the disruption caused by possessions, would in principle improve the alignment of incentives.

We consider that it would be preferable to take any such measure to improve alignment of incentives through the Franchise Agreement, rather than through the charging regime, as this would provide more flexibility to adapt the nature and extent of any arrangements to the specific commercial circumstances of individual franchises. This would also avoid the need to renegotiate existing franchises to apply the change.

Separately, DfT is concerned about the amount of resource expended on delay attribution between TOCs and NR, and would welcome measures that result in more productive approaches in this area.

Transmission mechanism

As set out in statutory guidance to ORR (July 2012), DfT supports consideration being given to the economic value of train services when decisions are made about prioritising different services.¹ Regardless of whether or not this is achieved through Schedule 8, DfT believes that there should be a robust transmission mechanism for ensuring that this policy is converted into operational practice within Network Rail.

Compensation rates

The methodologies used to set Schedule 8 payment rates (which also inform the calibration of Schedule 4) are essential if the incentive is not to be distorted, particularly given the significant financial flows involved. There was considerable debate around this subject in PR13 and a general consensus formed that more evidence was needed to support the setting of rates. DfT therefore supports early work in PR18, factoring in appropriate time for independent validation, to ensure that payment rates are set at the right levels, and that methodologies are transparent and understandable.

¹ *Secretary of State for Transport – Guidance to the ORR, paragraph 27 – July 2012:*
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/3642/sos-guidance-to-orr.pdf

Other issues

It has been argued to DfT that:

- the thresholds for train operators receiving sustained planned disruption (SPD) compensation do not always result in TOCs receiving sufficient compensation to mitigate disruption caused by engineering works
- in some circumstances, TOCs can incur non-refundable administrative costs for planned possessions which are subsequently cancelled by NR and
- arrangements for sustained poor performance (SPP) are difficult to apply.

DfT is not in a position to comment on these points in detail, but the ORR may wish to consider them as part of its review.

In conclusion, DfT believes that there are a number of areas to do with the scope and detailed design of the Schedule 4 and 8 regimes which need to be reconsidered, both from an industry and a public perspective. We look forward to engaging in the debate over how this can be achieved.

Yours truly

Richard Carter

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