OFFICE OF RAIL AND ROAD

PR23 – Review of the Schedule 8 train performance regime

Technical Consultation

Initial Proposals

17 June 2021

Contents

Executive Summary

In this consultation we present initial proposals for incremental reform of Network Rail's Schedule 8 train performance regime. Schedule 8 of track access contracts provides financial protection and incentives to minimise unplanned disruption and, as industry reform is implemented, these proposals can help ensure the regime remains fit for purpose for any interim period and on an enduring basis.

Schedule 8 was designed at the time of privatisation to compensate private operators for the long-term revenue impact of delays that they did not cause. It also acts as a performance incentive – Network Rail and operators are incentivised to reduce Schedule 8 payments by cutting delays they cause across the network. However, the dramatic changes driven by the COVID-19 pandemic have changed commercial dynamics in the industry and altered the effect of Schedule 8. Among other things, governments have replaced franchises with concession-style agreements and have brought services under greater direct public sector control or are in the process of doing so. These changes will have had the effect for private operators of removing revenue risk and most or all of the risk associated with Schedule 8 payments. This means that, for these operators, the incentive properties of the regime are significantly reduced, and its revenue protection function may no longer be needed.

The UK Government published the Williams-Shapps Plan for Rail ('the Plan') on 20 May 2021. This makes it clear that concession-style agreements will remain the dominant form of rail contract in use by the UK Government, to be let in future by a new body that will also run the railway infrastructure: Great British Railways. It also sets out a vision for the railway in which contracted operators have strong incentives to improve train performance and where the industry collectively works to improve the experience for passengers – replacing the current system which has multiple and uncoordinated incentives on different parties. It is also clear that the Plan envisages the industry wide delay attribution process, on which Schedule 8 relies, will change – moving instead to a system where industry is incentivised to work together and find solutions to reduce delays. The Plan does not change the powers and responsibilities held by the Scottish and Welsh Governments and other devolved rail authorities – but notes that there will continue to be a need for co-ordination across all parts of the network to ensure that the system can operate effectively as a whole.

We will support DfT as it develops its Rail Transformation Programme, including the development of the new generation of access contracts, the reform of delay attribution and the development of the system of performance incentives that will apply in the new industry structure. There will continue to be strong benefits of a coherent system which reflects the needs of operators which sit outside the remit of Great British Railways, as well as the interests of Transport Scotland, Transport for Wales, other devolved rail authorities and other infrastructure managers. This will be complex, and the nature and timing of changes to Schedule 8 need to be aligned with any changes to legislation and other changes to industry frameworks that could arise as Great British Railways is established, as well as with the plans of the devolved authorities. As a result, more substantial changes to Schedule 8 and delay attribution processes are best achieved through a co-ordinated programme which considers all these aspects.

We are of the view that, even after full implementation of the Plan, there remains a role for a mechanism such as Schedule 8 to provide revenue protection to fully commercial services such as freight and open access, and potentially to other operators that are given greater commercial freedoms around revenue sharing (an option left open in the Plan). A mechanism such as Schedule 8 can also serve to protect the long-term revenue receipts of the Scottish and Welsh Governments and other devolved rail authorities, and to protect the experience of passengers in these parts of the network, from disruption caused by other parties over whom they have no control. Given that there will continue to remain different responsibilities within the industry, contractual protections and incentives remain a powerful way to ensure that decisions are made with awareness of the impact on the whole system.

As a result, we are exploring the opportunities to make limited, incremental improvements to Schedule 8 which would address some existing issues with the regime and better align it with the vision set out in the Williams-Shapps Plan. This can ensure that Schedule 8 is fit for purpose for any interim period before full implementation of the Plan, and potentially to provide a baseline regime as a mechanism that could be adopted by Great British Railways after its creation.

This consultation therefore seeks views on the best approach for Schedule 8 in the 2023 Periodic Review of Network Rail (PR23), taking into account the changes in industry to date and the future changes that will happen over coming years. We are seeking views on whether we should make any changes to the regime as part of this review or leave any changes to be made through the government's Rail Transformation Programme. To support this decision, we have identified a number of changes that we could make to ensure Schedule 8 remains fit for purpose both in an interim period and potentially longer term:

- Change the way Network Rail's Schedule 8 performance benchmarks are set, to make the approach more straightforward and consistent between Network Rail and train operators.

- Update benchmarks annually to make them more flexible during control periods.
- Change how TOC-on-TOC delay is handled within Schedule 8 to address an existing gap in TOCs' incentives.
- Update the evidence base underpinning the freight regime.

We are also considering a small number of other possible changes, which could promote accuracy and industry co-operation, but on which we are inviting more views and information from stakeholders before concluding on whether these should be progressed.

All proposals and consultation questions are summarised in Annex 2.

Under any option, we will continue to work closely with DfT and the industry to understand in more detail the system of performance incentives that Great British Railways will establish, how transition from current arrangements will be achieved and how this will impact on services that will sit outside this body. We will also need to understand how Great British Railways will interact with Transport Scotland, Transport for Wales, other devolved rail authorities and other infrastructure managers. We will remain flexible in PR23 to respond as transition and implementation plans become clearer. We will also need to ensure that the performance regime can be flexible throughout CP7 – this will include considering how any changes made to delay attribution and the calculation of delay minutes should be reflected in Schedule 8 or a similar mechanism during the control period.

Please send responses to this consultation to performance.incentives@orr.gov.uk by 10 September 2021. We have made available a consultation response template which also contains information on publication of responses.

Our next steps are to consider the responses to this consultation, as well as developments in the Rail Transformation Programme. In the months ahead we will continue to engage with stakeholders and governments to develop proposals for Schedule 8 in PR23 – we will do this in a proportionate and targeted way, recognising the impact that the Rail Transformation Programme will have on industry resources. In early 2022, we intend to set out which proposals we plan to take forward and to seek further stakeholder views on the details of how these are implemented. This will be supported by impact assessments for all proposed changes, which will be informed by responses to this first consultation.

1. Overview of Schedule 8

What is the Schedule 8 performance regime?

1.1 Network Rail's train performance regime is intended to compensate train operators for the financial impact of unplanned service disruption caused by Network Rail and other train operators. This compensation reduces the risk to train operators in entering the market, investing and operating in the industry[1]. The regime is intended to provide financial incentives to Network Rail to improve train performance and to train operators to limit the delay they cause to other operators. The train performance regime is contractualised in Schedule 8 of track access contracts (this consultation uses the terms "performance regime" and "Schedule 8" interchangeably)[2]. A train performance regime is a requirement of the Railways (Access, Management and Licensing of Railway Undertakings) Regulations 2016[3] ("the 2016 Regulations").

1.2 Schedule 8 is part of a broader framework that affects train performance, which includes regulatory, commercial and contractual mechanisms, as well as reputational incentives. Work commissioned by us from SYSTRA and Steer show that they work at corporate and individual levels, with personal pride being particularly important for individuals. We will need to reflect on these findings more widely as part of PR23 – for example, in considering how the performance outcomes set for Network Rail's regions, or successor organisations, will drive behaviour and whether they effectively align with other incentives.

1.3 Performance incentives are also included within train operating agreements. These serve a different purpose from Schedule 8: incentives in operating agreements are typically focused on performance of TOCs' own services, whereas the focus of Schedule 8 is on each party's impact on system-wide performance (where a key objective of the regime is for operators to limit disruption caused to other operators[4]). Incentives in operating agreements and Schedule 8 have largely

[1] This has historically allowed operators to reduce the risk premia in train franchise bids, ultimately saving money for taxpayers – though this may now be a less significant purpose of Schedule 8.

[2] Separately, the Schedule 4 'possessions' regime compensates train operators for planned disruption such as line closures for engineering works. See paragraph 1.11 on ORR's plans to review this regime.

[3] Regulation 16(1) provides that "the infrastructure manager must establish a performance schedule as part of the charging system to encourage railway undertakings and the infrastructure manager to minimise disruption and improve performance of the network". In practice, this requirement is satisfied through the Schedule 8 performance regime.

[4] As we note below, this objective is currently fulfilled using the proxy measure of the delay a TOC causes to itself.

been calibrated separately – so assumptions, targets and payments are largely independent and may differ.

How does Schedule 8 currently operate?

1.4 Schedule 8 makes parties pay for the impact of the disruption they cause to other parties, based on a system of attributed delay, performance benchmarks and payment rates. If a party causes more (or less) delay than its benchmarked amount, it pays (or receives) an amount equal to the deviation from the benchmark multiplied by a payment rate. The focus on benchmarks means that operators are only compensated for some disruption, i.e. when there is a deviation from the benchmark. Payment rates in the passenger regime are designed to reflect lost future revenues based on passengers' responses to changes in train performance.

1.5 Key features of Schedule 8 include:

(a) The regime covers both delays and cancellations. In the passenger regime, each cancellation amounts to a defined number of 'delay minutes', reflecting the disruption that passengers face from having to wait for another train.

(b) Schedule 8 payments are determined formulaically based on performance in each railway period, rather than requiring parties to settle losses for each incident.

(c) The regime differs significantly between the passenger, freight and charter sectors. For example, in the passenger regime parameters are set at the level of TOC service groups[5], whereas in the freight and charter regimes parameters are set at the levels of the whole freight and charter sectors respectively.

(d) Schedule 8's parameters – principally benchmarks and payment rates – are calibrated at each periodic review for the duration of the control period. They can be recalibrated during the control period under some limited circumstances, though scope for flexibility is greater in the passenger regime than in the freight or charter schemes.

(e) Schedule 8 is dependent on information from delay attribution processes (see paragraphs 2.17 to 2.20 for an update on delay attribution).

[5] Service groups aggregate each TOC's train services within distinct geographical routes, e.g. Chiltern Railways Oxford services.

1.6 The regime is explained in an accompanying factsheet, and more detailed guidance is also available.

1.7 Some parties in the industry have entered into commercial side-agreements ('overlay' contracts) which sit alongside Schedule 8 and can alter the financial impacts of disruption for the parties involved. Network Rail and some operators continue to have interest in pursuing overlays to address operator-specific concerns with Schedule 8. ORR's position on overlays is as set out in our letter of March 2020 where we highlighted principles for parties to recognise and observe such as non-discrimination and transparency.

Is Schedule 8 effective?

1.8 Our stakeholder engagement has produced a mix of views on how Schedule 8 fulfils its two key functions to provide financial protection against unplanned disruption and to create incentives to improve performance on the network[6].

1.9 In respect of Schedule 8's key purposes:

(a) Regarding the **passenger regime**, the regime has, for parties exposed to Schedule 8, provided strong financial incentives to improve train performance, including to make the business case for investments that enhance punctuality and reliability. Operators have expressed concern that, without strong financial incentives, Network Rail would be less motivated to prevent disruption and recover quickly from incidents. However, stakeholders have highlighted some weaknesses in Schedule 8, as summarised below, and the regime is also affected by changes in the industry (see chapter 2).

(b) Regarding the **freight regime**, freight sector stakeholders believe that the regime is largely fit for purpose. Freight operators rely upon the protection offered by the regime to offset the financial consequences of disruption, and financial incentives are needed for parties to consider the performance impact of their decisions. The need for a financial incentive regime is likely to endure for freight operators in a future reformed industry.

1.10 Alongside the benefits and ongoing value of the Schedule 8 regime, stakeholders have raised a number of concerns which may contribute to adverse outcomes for train performance.

[6] Engagement has included the findings of the SYSTRA report as well as discussions with the industry including Network Rail, DfT, Transport Scotland, passenger operators, freight operators and freight customers.

(a) Schedule 8's **incentive properties may be incomplete** and do not always work as intended. This can result in weak incentives for parties to act in the interests of system-wide performance. Some gaps in incentives have resulted from efforts to avoid over-complicating the regime, highlighting a trade-off that sometimes exists between the accuracy of incentives and the simplicity of the regime.

(b) Schedule 8, particularly the passenger regime, is seen as **complex** and, as a result, **not always well understood**. The fundamental elements of Schedule 8 are reasonably straightforward, but certain features of the regime and its calibration add complexity, often resulting from steps to increase accuracy and consistency. This can make the regime harder to understand, making incentive effects less straightforward to act upon.

(c) The Schedule 8 regime also **lacks flexibility** and may not respond well to changing circumstances. Key inputs such as benchmarks and payment rates are fixed at the start of each control period, and do not automatically adjust during the period to external changes such as shocks to demand[7]. This potentially means that the regime is not well calibrated if circumstances change during the control period. The situation can result in volatile payment flows that stem from external shocks rather than from measures taken to improve performance, and which therefore lack fairness[8].

(d) Schedule 8 is associated with a culture that we have been told **can discourage collaboration**. Stakeholders have told us that the large sums at stake in the regime can result in excessive arguments in the delay attribution process. Financial incentives are always likely to be associated with disputes between parties, but there might be scope for changes to improve the culture, either within delay attribution (see paragraphs 2.17 to 2.20) or the terms of Schedule 8.

Related consultation on Schedule 4

1.11 Through Schedule 4 of track access contracts, Network Rail pays compensation to operators for revenue losses and additional costs arising from planned disruption

[7] In the passenger regime, recalibration is possible under certain circumstances, for example if there has been a re-mapping of TOCs' operating geographies – see ORR guidance paragraphs 28-40.

[8] The experience of COVID-19 provides one such example – Network Rail and many operators have been significantly outperforming their benchmarks, as much lower levels of congestion have improved punctuality, and this has resulted in large net payment flows towards Network Rail. It is probable that future 'shocks' will be of a different nature and could result in payment flows in either direction.

when Network Rail introduces blockades on the network (“possessions”). It acts as a financial incentive on Network Rail to reduce disruption to services by improving its possessions management. Schedule 4 is linked to Schedule 8 in that its revenue loss compensation is based on Schedule 8 payment rates. We plan to issue a separate consultation on options for Schedule 4 in September 2021.

2. ORR's proposed approach and priorities

2.1 This section sets out ORR's proposed approach in PR23, in light of changes to the industry's commercial structures, rail reform and our appraisal of the current Schedule 8 regime.

Adapting to industry change

2.2 We are starting PR23 at a time of significant change and uncertainty. The industry's rapid structural change in response to COVID-19 has already affected the way Schedule 8 works for many, though not all, operators. Among other things, governments have replaced franchises with concession-style agreements and have brought services under greater direct public sector control or are in the process of doing so. These changes will have had the effect for private operators of removing revenue risk from these operators and most or all of the risk associated with Schedule 8 payments. This means that, for these operators, the incentive properties of the regime are significantly reduced, and its revenue protection function may no longer be needed.

2.3 However, there continue to be train operators that are fully exposed to Schedule 8. Freight, charter and open access passenger operators remain purely commercial operations that are not contracted by a public body. The changes to the contracting model also do not directly change Network Rail's incentives. In the current structure it remains important that Network Rail's incentives to deliver a high-quality service are aligned with operators – Schedule 8 currently plays a role in achieving this.

2.4 The Williams-Shapps Plan will bring further change. It confirms (page 54) that arrangements which build on concession-style contracts will be the dominant model for rail contracts let by the UK Government and in future Great British Railways. The Plan makes clear that these agreements will have strong incentives to improve train performance, including through a focus on operators and the infrastructure manager coming together under the new body to improve performance across the network as a whole. Great British Railways will need to develop its own set of performance incentives to achieve this; we expect these to be designed as part of the Rail Transformation Programme which is now being set up.

2.5 However, even once the vision in the Plan is fully implemented, Great British Railways will not encompass the whole of the rail industry. There will remain fully commercial operators such as freight, charter and open access operators, which will remain exposed to revenue risk. In addition, the Williams-Shapps Plan leaves open the option that in future operators could be given greater commercial freedoms around revenue. A mechanism like Schedule 8 would play a role in reducing the commercial risk to these operators from investing and operating in the railway.

2.6 The Plan also does not seek to change the powers and responsibilities held by the Scottish and Welsh Governments and other devolved rail authorities. As currently, the long-term revenue receipts of these parties, and the experience of passengers in those parts of the network, will be impacted by the performance of the infrastructure manager and other operators, over which they have limited control. A mechanism like Schedule 8 can therefore have a role in providing some protection against this risk. In addition, a financial incentive on parties to take into account the delays they cause to the whole network can still be a powerful way to ensure that they take decisions in the interests of the whole system. Schedule 8 could provide the foundation for a baseline regime that applies to these operators in future.

Approach to PR23

2.7 Given the changes to date, and the future changes that will happen over coming years, we have considered the best approach to PR23. Current legislation places requirements on an infrastructure manager to have a performance regime, which is currently fulfilled by Schedule 8. Any legislation resulting from the Williams-Shapps Plan that might change this requirement is unlikely to be in place by the time we need to take key decisions on the Schedule 8 framework to enable changes to be implemented for the start of CP7. We are therefore starting from the requirements in the existing legislation.

2.8 We have considered whether to make radical changes to Schedule 8 for PR23 – for example by significantly scaling back the regime for operators on concession-style contracts. This could allow us to anticipate changes that may be made to the contractual framework that will apply to Great British Railways in future. However, to be effective, changes to Schedule 8 need to be aligned with wider changes to industry being delivered through the Rail Transformation Programme. We therefore think that more radical change would likely be best achieved in a co-ordinated rail reform programme which designs a coherent set of new industry frameworks in line with the vision set out in the Williams-Shapps Plan. This will also need to reflect the needs of operators that sit outside the remit of Great British Railways, as well as the interests of Transport Scotland, Transport for Wales, other devolved rail authorities and other infrastructure managers.

2.9 We also note Regulation 16(3) of the 2016 Regulations which requires that the regime must apply in a non-discriminatory manner throughout the network – we consider this currently limits the ability to remove or radically change the regime for some passenger operators but retain it for others. This means that Schedule 8 will remain in place for all operators, including for those where the regime is treated as a pass-through to a rail authority (i.e. where the operator is not financially exposed)[9]. We would welcome views on the implications this has for funders and how this could be managed.

2.10 We have also considered the option to make no changes to the Schedule 8 framework at all – this would retain the current regime in PR23, recalibrated using new data. This remains an option and would reduce the administrative impact of PR23 on industry. However, this would leave a number of known issues with the regime unaddressed and would reduce the extent to which Schedule 8 is fit for purpose as a future baseline regime.

2.11 For PR23, we are therefore minded to proceed on the basis that we retain the existing broad Schedule 8 framework for all operators, with similar purpose and objectives to those for PR18 (see Annex 1), but to consider some incremental and proportionate changes. We have identified a small number of areas we consider as priorities for reform as well as a few others on which we also welcome views from industry – these are set out in more detail in the section below. We are seeking views on this overall approach.

2.12 Under either high-level option – no change or incremental change – we will continue to work closely with DfT, Transport Scotland, Transport for Wales, other devolved rail authorities and industry to understand in more detail how the existing system of performance incentives will change, and how industry will transition from current arrangements. We will remain flexible to respond as these plans become clearer – this may change the approach we need to take in PR23 as we progress through this period.

[9] Also see paragraph 1.7 regarding the use of commercial side-agreements (‘overlays’) between parties to address operator-specific issues, which can alter financial flows in Schedule 8. ORR’s position remains as articulated in our March 2020 letter.

Priority areas for incremental reform

2.13 We have reviewed options for limited and proportionate incremental changes to Schedule 8 which could bring benefits to rail users and taxpayers. In doing so, we have considered the assessment of Schedule 8 we set out in the previous chapter, previous work in PR18, the SYSTRA report, discussions with the industry including Network Rail, DfT, Transport Scotland, operators and freight customers, and the vision for the future rail industry articulated in the Williams-Shapps Plan.

2.14 We have identified four proposals that we consider we should progress as a priority. These are:

Proposals cross-cutting across the passenger and freight regimes:

- Change the way Network Rail's benchmarks are set, to make the approach more straightforward and consistent between Network Rail and train operators.
- Update benchmarks annually to make them more flexible during control periods.

Proposal specific to the passenger regime:

- Change how TOC-on-TOC delay is handled within Schedule 8 to address an existing gap in TOCs' incentives.

Proposal specific to the freight regime:

- Update the evidence base underpinning the calibration of the freight regime.

2.15 In addition, we are also considering a small number of additional changes, which could promote accuracy and industry co-operation, on which we are inviting more views and information from stakeholders before concluding on whether these should be progressed. These are:

Proposal cross-cutting across the passenger and freight regimes:

- Share allocation of some types of delay within Schedule 8, to help to reduce a possible barrier to industry collaboration.

Proposals specific to the passenger regime:

- Change the allocation of delay within Schedule 8 for unidentified incidents to make the split more accurate.

- Change Schedule 8 compensation to more fully reflect the financial impacts of delay, making compensation more accurate and incentivising parties to take account of the full cost of delays they cause.

Proposal specific to the freight regime:

- Revisit the levels of the freight incident and annual caps, and the supplements paid to benefit from them.

2.16 These proposals are discussed further in the subsequent chapters. We assess these proposals in light of the proposed objectives for the regime as set out in Annex 1.

Delay attribution

2.17 The delay attribution process delivers a key input into Schedule 8 calculations in the form of delay minutes allocated to each party. Attribution of delays is also a legal requirement under the 2016 Regulations[10]. The Williams-Shapps Plan (page 15) considers that there is a need to radically reform the current delay attribution process. It acknowledges that delay attribution "plays an important role in measuring performance across track and train" but suggests that "it is symptomatic of a misaligned focus on blame, rather than solutions".

2.18 These issues have long been recognised, and ORR and the industry have sought to address some of them through incremental change, most recently in the RDG steering group report in 2020, carried out following our scoping study in 2019. However, given the wide-ranging reforms to the structure and operation of the industry set out in the Plan, there is an opportunity to progress fundamental reform to delay attribution, led through the UK Government's Rail Transformation Programme.

2.19 When assessing the priorities for incremental change to Schedule 8, we have identified some areas where we can make improvements to address some of the

[10] The regulations create a requirement for delay attribution and set out a list of delay classes to which all delays must be attributable (Regulation 16(3) and Schedule 3 paragraph 7(4)). This requirement is satisfied for the Network Rail performance scheme through the delay attribution process detailed in Part B of the Network Code ('Performance Monitoring').

concerns regarding the willingness of industry to come together to solve cross-industry problems for the benefit of customers. However, the current delay attribution process has a wider relevance than just Schedule 8. It is closely linked to operational systems and processes and is currently the basis for calculation of financial performance incentives in train operating agreements. We will actively support industry efforts to improve current processes, both on an interim basis and through introduction of new processes and systems once Great British Railways is created.

2.20 We will also ensure that as far as possible Schedule 8 can accommodate changes to underlying delay attribution principles and rules during CP7, including as part of the recalibration process.

Consultation questions

Question 1: Do you have any views on the objectives and benefits of a mechanism such as Schedule 8, for the range of different industry parties, both in the current contracting model and once the Rail Transformation Programme has been fully implemented?

Question 2: Do you have any views on whether we should make no changes to Schedule 8 in PR23, or pursue a small number of incremental reforms to ensure it remains fit for purpose as a baseline regime?

Question 3: Do you agree with the areas we have identified as priorities for PR23? Are there any other significant issues that we should seek to address?

3. Proposals: Cross-cutting changes across sector regimes

3.1 The previous chapter has concluded that a mechanism such as Schedule 8 retains value but there could be scope for incremental reform to improve its operation. In this and the following chapters we set out further details of the options we could take forward to improve the regime as part of PR23.

3.2 This chapter covers proposals that are cross-cutting across the passenger regime and one or both of the freight and charter regimes.

A. Setting Network Rail's benchmarks based on past performance

3.3 We have identified that one priority for PR23 should be changing the way Network Rail's benchmarks are set, to make the approach more straightforward and consistent between Network Rail and train operators.

3.4 This change would be applied to the passenger and freight regimes. (The charter regime is already calibrated based on Network Rail's past performance, so the change is not relevant to that sector.)

Current approach

3.5 Schedule 8 payments are based on outturn performance relative to performance benchmarks. Network Rail's benchmarks are informed by forward-looking regulatory performance trajectories determined at the start of the control period through the periodic review. In contrast, train operators' benchmarks are based only on past performance. In PR18, for the passenger regime, regulatory performance trajectories were subject to discussion between Network Rail and operators, with ORR making a determination if agreement could not be reached. For the freight regime, there is a single freight benchmark based on Network Rail's forward-looking regulatory performance trajectory for the freight sector. Linking benchmarks to trajectories has the benefit of helping to align Network Rail's benchmarks with regulatory expectations.

Issues with the current approach

3.6 The current approach to setting Network Rail's benchmarks, based on forward-looking trajectories, adds complexity to the calibration of the regime, which in previous periodic reviews has put pressure on industry resources in the calibration period. It may also encourage parties to be led by Schedule 8 implications when discussing trajectories, at the expense of fostering collaborative working relationships. It also limits the scope for flexibility during the control period when regulatory trajectories are fixed at the time of the periodic review.

3.7 The current approach also implies a different method for Network Rail and train operators, which might be inconsistent with the desire of governments to align incentives across the whole system.

3.8 Lastly, there is likely to be a significant challenge in forecasting performance in CP7 given uncertainties around rail demand and service volumes, which could mean that Network Rail's performance trajectories are more uncertain than usual. (At the same time, there is also a challenge to establishing a reliable reference period on which to base alternative historical averages.)

3.9 We therefore consider there is value in exploring alternatives that remove the link to future performance within Network Rail's benchmarks, and we are proposing that the following change should be a priority in PR23.

Proposed change A: Base Network Rail's benchmarks only on past performance

3.10 If we proceed with making incremental reforms to PR23, we propose to base Network Rail's benchmarks on historical data alone, without adjustment for forward-looking regulatory trajectories. This is the approach currently followed in relation to operators' benchmarks.

3.11 We consider that this option has the following benefits:

(a) It allows Network Rail's benchmarks to benefit more completely from steps to improve flexibility (as per Proposal B below), which in turn can improve accuracy. Best expectations of future performance may be better inferred from recent past performance than from a long and progressively outdated forecast.

(b) It simplifies the process through which Network Rail's benchmarks are set, reducing resource pressures.

(c) It aligns the approach to setting the benchmarks for Network Rail and train operators, which may have a benefit in its own right as the rail reform agenda seeks to align track and train.

3.12 We note that this proposal would remove the link between benchmarks and any performance trajectories that might be established, which may create the impression of misaligned targets and weakened incentives on Network Rail to improve train performance. It is worth noting though that Network Rail would still face strong incentives to improve performance at whichever level benchmarks are set[11].

3.13 Under this proposal, the link with past performance could mean that there may be an incentive on Network Rail to underperform against benchmarks in one year in order to benefit from lower benchmarks in the following periods. There are some mitigants to this risk, such as the broader set of incentives and regulatory safeguards on Network Rail's performance, but we welcome views from stakeholders on the significance of the risk.

Consultation questions

Question 4: Would you support Proposal A? Do you have any views on the proposed methodology set out?

B. Annually updating Schedule 8 benchmarks

3.14 If we proceed with incremental change for PR23, we have identified that a further priority should be annually updating benchmarks to make them more flexible during control periods.

3.15 This change would be applied to the passenger, freight and charter regimes.

Current approach

3.16 Schedule 8 benchmarks are currently determined at the time of each periodic review and are fixed for the duration of the control period. Within the control period, passenger operator benchmarks can only be changed in some limited circumstances[12], while the freight regime does not include a mechanism through which benchmarks can be changed. The key advantage of this approach is that

[11] In the absence of floors and caps, each minute of delay is subject to the same payment rate, regardless of whether lateness is above or below the benchmark, or proximity to the benchmark.

[12] During a control period, either party to the access contract can propose a recalibration of benchmarks, for which they need to seek ORR's approval. If parties do not agree, either party can refer the matter to ORR; ORR then decides whether and how to determine the matter. ORR has provided guidance on the different types of mid-control period recalibration that we would consider (paragraphs 28 to 40).

the calibration process only needs to happen once every five years, limiting administration costs, and it provides clarity and certainty for the five-year period.

Issues with the current approach

3.17 As a general principle, benchmarks should be aligned with the best expectation of future performance in order to optimise the accuracy of the regime. Fixing benchmarks for the duration of the control period means that they do not automatically respond during the period to external changes such as shocks to demand. This potentially means that the regime is not accurately calibrated if circumstances change during the control period – for example, benchmarks may be fixed higher or lower than newer expectations of performance.

3.18 In such a situation, the intended incentive properties of Schedule 8 remain largely intact in that, regardless of where benchmarks are set, parties benefit financially from improving performance relative to those benchmarks. But this may result in volatility in payment flows that stems from external shocks or forecasting errors rather than from measures taken to improve performance (i.e. akin to windfall gains and losses). There is therefore value in exploring ways for the regime to adapt more readily to changing circumstances.

Proposed change B: Annual updates to make benchmarks more flexible

3.19 If we proceed with incremental reform, we propose therefore to introduce annual updates of benchmarks during the control period, allowing for benchmarks to respond to shocks and therefore to reflect changing circumstances.

3.20 This proposal has the benefit of more quickly reflecting changes in network activity caused by external shocks. This reduces the scope for volatile and unfair payment flows that result from benchmarks failing to respond to changes in circumstances. There may be a downside in that benchmarks respond to short-term changes in performance that are subsequently reversed, which would increase the volatility of flows – but this is already a risk under the current process and assumptions about performance are 'baked in' for a full five years.

3.21 This change could be achieved in one of two ways, on which we welcome input from stakeholders[13]:

(a) **Option B1 – Rolling historical performance.** This would involve updating, each year, the past performance component of benchmarks using average outturn performance during a set period of time in the past. This period would move forward by a year each time benchmarks are recalibrated. Potentially this rolling period could be for a period as long as five years, striking out the top and bottom observations as potential outliers.

(b) **Option B2 – Modelled approach.** This would mechanistically adjust benchmarks each year based on changes in network traffic levels observed during the past year. Applying this kind of annual adjustment would cause benchmarks to increase when network traffic increases, according to a pre-set formula based on the historical correlation between traffic and performance.

3.22 As noted in a box later in this chapter on 'Calibration challenges in PR23', a significant issue for the calibration of Schedule 8 in PR23 is how to establish a credible data reference period for Schedule 8 which deals with the heavy disruption caused by COVID-19. Options B1 and B2 could help to address the challenge by responding quickly to changing circumstances as the industry recovers. We invite stakeholder views on this issue and how the options could be shaped to address it.

3.23 We note that, in PR18, we removed a mechanism from the freight regime that made an adjustment to FOC benchmarks based on traffic volumes[14]. We removed the adjustment on the basis that it would both simplify the regime and improve the signals to operators about the impact of the delay they cause. However, COVID-19 has brought to the fore the importance of flexibility in the contractual and regulatory regime, so we welcome views from the freight sector on the value of such a mechanism. In reaching a preferred way forward, we will take into account all relevant factors including the arguments considered in PR18.

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[13] For Network Rail's benchmarks there may be a dependency between Proposals A and B. Currently Network Rail's performance benchmarks are based on forward-looking trajectories set at the start of the control period. If Proposal A, to base Network Rail's benchmarks on historical performance, was not adopted, then this would limit implementation of Option B1 (to update benchmarks annually based on historical performance) for Network Rail's benchmarks. The modelled approach in Option B2 could be more fully feasible.

[14] Final Decision: Proposal to remove the annual adjustment to the freight and charter operator Schedule 8 benchmarks (March 2018).

Consultation questions

Question 5: Would you support Proposal B? If benchmarks were to be updated annually, do you favour achieving this through a rolling update (Option B1) or through a modelled approach (Option B2)?

C. Shared allocation of delay within Schedule 8

3.24 We are open to options to better align PR23 with the direction of rail reform to include better incentives to collaborate. One way to achieve this is to move to sharing allocation of some types of delay within Schedule 8, helping to reduce a possible barrier to industry collaboration. We invite further comments from stakeholders on whether this change would be proportionate and demonstrate clear value in relation to the regime's objectives and our priorities for PR23.

3.25 This change could be applied to the passenger, freight and charter regimes.

Current approach

3.26 At present, the industry's delay attribution processes typically allocate a delay incident to a single party. This in part reflects the legal framework, as per the 2016 Regulations, which state (Schedule 3, paragraph 7(5)): *"Wherever possible, delays must be attributed to a single organisation, considering both the responsibility for causing the disruption and the ability to re-establish normal traffic conditions."*. This appears to limit the scope for the delay attribution system to attribute delays to multiple parties. The Delay Attribution Principles and Rules (section D2) set out the limited circumstances currently permitted for joint responsibility.

3.27 Schedule 8 generates financial payments based on this attribution of delay to one or other party. For the limited number of jointly attributed incidents, delay minutes are allocated 50/50 between parties[15].

Issues with the current approach

3.28 Network Rail argues that the current system, under which delays are generally attributed to a single party, often does not consider that there are multiple contributing factors, and that more than one party can mitigate risks or aid in recovery from a delay event. For example, it argues that the risk of suicides on the network can be mitigated by both Network Rail, through its management of track

[15] Model passenger contract, Schedule 8, paragraph 5.4(b).

infrastructure, and train operators, through their management of many stations. At present operators may lack incentives to invest in mitigation initiatives. The current system may also result in a culture of blame rather than collaboration to jointly mitigate risks and to recover services quickly when incidents do occur.

3.29 Network Rail argues that work should be carried out to better understand how responsibility for delays could become a shared or joint enterprise. It argues for responsibility to be shared between parties for more types of incidents, and for flexibility on the exact split of responsibility. Under this proposal, 'joint responsibility' would assume a 50/50 attribution of delays, whereas 'shared responsibility' could assume a different split depending on a balance of responsibility, e.g. 60/40 or 70/30.

Proposed change C: Joint or shared allocation of delay minutes within Schedule 8 itself

3.30 ORR will actively support industry efforts to improve delay attribution processes. In addition, we are open to exploring changes to Schedule 8 itself to allow for a different allocation of delay minutes for certain categories of delay. Under this proposal, Schedule 8 would treat certain classes of delay as joint or shared for the purpose of allocating delay minutes in the calculations that determine financial flows. Delay attribution itself would be unchanged. This approach could be taken to categories of incident where more than one party is normally in a position to mitigate risks and aid service recovery.

3.31 Our initial view is, firstly, that this change could have the benefit of financially incentivising all parties to mitigate risks and aid service recovery. However, a change would cause a break between delay attribution and Schedule 8, such that a party could make payments under Schedule 8 where no delay has formally been attributed to it. This could cloud overall responsibility. We also see downsides in that it would add complexity to the terms and calibration of Schedule 8, and in complicated incidents involving multiple operators it may not be straightforward to determine which parties should share in the allocation. There may be an inconsistency in the treatment of delays between different industry processes, which could cause confusion. A key question is whether parties favour changes to be made 'at source' in delay attribution itself through greater use of joint attribution.

3.32 We invite stakeholders' views on whether this proposal would bring clear benefits and can be practically implemented within Schedule 8.

Consultation questions

Question 6: Should Proposal C be a priority for reform in PR23? If you would like us to consider Proposal C further, please set out how it can best be implemented (e.g. including incident types that should be subject to joint or shared responsibility).

Other ideas considered by ORR

3.33 We have considered a number of other ideas for reform of Schedule 8 but which we are not at this time proposing to take forward. Annex 3 presents ORR's initial views on the merits of these options. We welcome stakeholders' views on these initial assessments and whether the options should instead be considered as priority areas for reform in PR23.

Calibration challenges in PR23

Schedule 8 is calibrated at each periodic review in a process that updates key parameters to reflect new evidence, ahead of applying those parameters for the new control period. For example, in PR18 performance benchmarks were updated to reflect recent past performance and, in the case of Network Rail's benchmarks, expected future performance. The PR18 calibration used two recent years of reference data to inform the calculations. As a further example, payment rates are updated at the periodic review to reflect any new evidence on the financial impact of disruption – for example, in the passenger regime, how passenger demand responds to delay.

In PR18, the calibration work was led by RDG, with the consultants Steer carrying out detailed analysis summarised in a methodology report.

In PR23 there will be an unusually complex set of challenges for the calibration of the regime due to the impact of COVID-19 on the industry, which has very significantly affected volumes of traffic and passengers on the network. Challenges will include:

- Train performance data from 2020-21 and 2021-22 will be affected by lockdowns, while subsequent years will most likely be characterised by progressive recovery. It will therefore not be obvious what traffic and historical performance data to use to inform Schedule 8 parameters.
- The nature of demand has changed, perhaps permanently – passenger numbers have been highly subdued in 2020-21 and 2021-22, and demand patterns may be

enduringly different, especially in commuter markets. It is also possible that there may have been changes in how demand responds to disruption. To a lesser extent, issues around changing demand may also exist in freight. This changing picture for demand will influence the calibration of payment rates for CP7.

In addition, there is an ongoing RDG-led study into the impacts of disruption, which may provide additional evidence for the PR23 recalibration, potentially changing the level of payment rates.

While this current consultation is focused on the overall framework for Schedule 8, ORR and the industry will also need to turn attention to these calibration issues in the months ahead, and we welcome any early stakeholder views on how to respond to the challenges.

4. Proposals: Passenger regime

4.1 Chapter 2 has set out that the Schedule 8 passenger regime retains value but there could be scope for incremental reform to improve its operation. In addition to the cross-cutting proposals in chapter 3, we have identified a further three areas of potential improvement to the passenger regime, as set out in this chapter. (These proposals continue sequentially from the previous chapter.)

D. Treatment of TOC-on-TOC delay in Schedule 8

4.2 We have identified that, if we proceed with incremental reform, a priority for PR23 should be to change how TOC-on-TOC delay is handled within Schedule 8, to address an existing incentive gap in TOCs' incentives in considering delay caused to other operators.

Current approach

4.3 The Schedule 8 passenger regime is intended to incentivise operators to minimise the delay they cause to other operators. At present, the measure of passenger operator performance is based on the proxy of the delay that operators cause to themselves – this is known as 'TOC-on-Self' delay. When the regime is calibrated ahead of each control period, empirically derived assumptions are made about the relationship between delays that operators cause to themselves and the amount of delay caused to other operators. These assumptions are reflected in Schedule 8 parameters at the point of calibration through a TOC 'responsibility matrix'. The update of the matrix at each control period may provide a limited incentive on operators to limit the delay they cause to others[16].

4.4 The TOC-on-Self approach is currently used due to limitations in systems that have restricted the industry's ability to trace impacts of delays caused by one party on other parties.

Issues with the current approach

4.5 Due to TOCs' benchmarks relating to their <u>own</u> delay minutes, the current system significantly limits financial incentives for TOCs to invest in initiatives to reduce the delay they cause to <u>other</u> operators as distinct from delays caused to themselves,

[16] If a TOC causes less delay to other operators than in the previous reference period, this will be reflected in the responsibility matrix and the TOC's payment rate will be reduced. To the extent that the TOC favours a lower payment rate, which reduces the TOC's risk exposure, this provides an incentive for it to limit the delay it causes to other parties.

or to take decisions that help mitigate reactionary delays. Network Rail has argued that TOCs have an important role to assist in service recovery and manage reactionary delay.

4.6 A further consequence can be that Network Rail, which is exposed to the actual cost of reactionary delay, can face outgoing payments which are different from incoming payments from operators – a potential source of imbalance in the star model[17].

4.7 ORR last looked at the issue of TOC-on-TOC delay in PR18, where we identified that the current approach may be adverse for TOCs' incentives but decided not to change the measure of passenger operator performance (paragraphs 81 to 95). We stated: *"While there are benefits from improving the measurement of the delays caused by passenger operators, we have decided to retain the current method for CP6. This is in order to allow reforms to the regulation of system operation to be implemented fully and to provide time to reform delay attribution processes."*. In our conclusions we noted that ORR "remains of the view that TOC-on-TOC measurement has the potential to improve outcomes and to align operator incentives with the interests of users across the network", and "we will be looking to ensure that the necessary reforms are delivered over CP6 to introduce this approach in PR23" (paragraphs 90 to 91).

4.8 Since PR18, regulation of the system operator function has bedded in. ORR has also carried out a review of delay attribution, with a number of steps now being taken forward by industry parties and further work possible[18].

Proposed change D: More accurately incentivise TOCs to limit delay to other operators

4.9 To address this issue, we would propose to move towards an approach that more accurately incentivises TOCs to limit delay to other operators. The key benefit of this proposal is that it encourages operators to help to mitigate reactionary delay, though the incentive effect would be lower for operators on concession-style contracts. The change would improve the functioning of the star model by better aligning the sums that Network Rail pays in relation to reactionary delay with the amounts received from operators.

[17] See the accompanying factsheet for a summary of the star model. This imbalance can emerge if the relationship between TOC-on-Self delay and TOC-on-TOC delay diverges over time, such that TOCs' payments for delays caused to themselves are not a good reflection of the delays they cause to others.

[18] See paragraphs 2.17 to 2.20 regarding work on delay attribution.

4.10 This change could be achieved either by moving to a TOC-on-TOC measure of operator performance, or through an annual update of the TOC responsibility matrix. We present these options below.

Option D1: Change the measure of operator performance from a TOC-on-Self to a TOC-on-TOC measure

4.11 Under this option we would change the measure of TOC performance from TOC-on-Self delay to one based on TOC-on-TOC delay, directly measuring delay minutes caused to other operators. This is the current system in the freight regime and is similar to the proposal that we considered implementing in PR18.

4.12 This would make the regime's incentives more accurate, better reflecting the impact that TOCs have on other operators. It would incentivise operators to aid service recovery and to take decisions that minimise adverse impacts on other operators.

4.13 However, this option would reduce financial incentives on Network Rail to help the system recover quickly from delays caused by TOCs, because Network Rail would as a result be less exposed to the financial impacts of delays it has not caused. It would also expose TOCs to some financial risks over which they may have limited control, given that TOCs have only partial influence on the wider system beyond recovery of their own services[19]. There would be some administrative costs to the change. In particular, the ability of Network Rail's PEARS system to provide data to support this option is not yet clear, so Network Rail would need to undertake an initial capability assessment followed by any necessary systems changes.

Option D2: Update payment rates annually through a rolling update of the TOC responsibility matrix

4.14 An alternative option to address this issue would be through an annual update of the TOC responsibility matrix, which is currently only updated every five years. The update of the matrix provides an incentive on operators to limit the delay they cause to others, to the extent that TOCs prefer to have lower payment rates in order to reduce financial risk. However, this incentive is currently somewhat weak due to the lag before the matrix is reflected in payments and the exclusion of some years from the reference period.

4.15 Under this option we would preserve the TOC-on-Self measurement of delay, while annually reflecting changes in the relationship between the delay an operator

[19] One way to mitigate this would be through caps that limit operators' exposures to individual incidents and/or annual costs.

causes to itself and the delay caused to others. Operator payment rates would reflect the updates to the responsibility matrix, which would increase the accuracy of the passenger regime. It would also sharpen TOCs' incentives regarding the delay caused to others (to the extent that they prefer lower payment rates), albeit by less than under Option D1. It would continue to expose Network Rail to the costs of reactionary delay, which may be appropriate to the extent that it has greatest influence over system recovery. There would though be an administrative cost in carrying out the annual update of the matrix – this may be more burdensome than the current five-yearly update, so needs to be weighed against the benefits of a change.

4.16 Overall, we prefer Option D2 over D1. It would improve the accuracy of TOCs' incentives, while maintaining Network Rail's incentives to manage reactionary delay, and is also likely to be more straightforward to implement using existing systems.

Consultation questions

Question 7: Would you support Proposal D, implemented through Option D2? Do you have any views on the options set out?

E. Change to allocation of delay within Schedule 8 for unidentified incidents

4.17 Another potential improvement in PR23 is to change the allocation of delay within Schedule 8 for unidentified incidents to make the split more accurate. We invite further comments from stakeholders on whether this change would be proportionate and demonstrate clear value in relation to the regime's objectives and our priorities for PR23.

Current approach

4.18 There are some delay incidents where there is insufficient information to determine a primary cause, which Schedule 8 terms as "unidentified incidents". They can include sub-threshold delays when the initial delay is below a three-minute threshold but the subsequent delay is above the threshold and a cause cannot be found for the initial delay.

4.19 The Schedule 8 passenger regime provides that responsibility for unidentified delays shall be allocated as follows[20]:

(a) 50% of unidentified delay minutes are allocated pro rata between Network Rail and TOC based on the split of attributed delay minutes for that service group on that day; and

(b) the balance (50%) of delay minutes is allocated to Network Rail.

4.20 For example, if Network Rail causes 60% of all attributed delays to a service group on a given day, then 80% of unidentified delays for that service group on that day will be allocated to Network Rail[21].

Issues with the current approach

4.21 Network Rail has said that the current allocation of unidentified delays is not based on evidence about which parties cause delays. It suggests that most unidentified delays relate to sub-threshold delays, and that the allocation does not reflect the reality of the likely cause of sub-threshold delays. It has told us that Network Rail is responsible for just over 55% of delays which are three minutes in length (i.e. the minimum level at which delays are normally attributed), and it believes this proportion is likely to be smaller for sub-threshold delays. If correct, this could imply that Network Rail is currently allocated an excessive amount of delay for unidentified incidents.

Proposed change E: Change the allocation of unidentified delays between Network Rail and operators

4.22 Network Rail has suggested that there should be a rebalancing of responsibility for unexplained delays, and that new analysis should be conducted to better understand the causes of unexplained delays and which party is best placed to mitigate them. This could lead to a changed methodology for allocating unidentified delays. The benefits of this change would be to better understand the causes of sub-threshold delay and achieve a fairer allocation of responsibility within Schedule 8.

4.23 A counterargument is that the current methodology places a strong incentive on Network Rail to establish a primary cause for delays. This could be appropriate

[20] Model passenger contract, Schedule 8 paragraph 5.5. The allocation occurs when there are other delay minutes in respect of the service group on which the pro rata calculation can be based. Otherwise a 50/50 split occurs between Network Rail and train operator.

[21] This is equal to (½ * 60%) [pro rata allocation] + 50%.

given Network Rail's central role at the first stage of delay attribution: its investigators determine causation and attribute delays to codes ahead of review by TOC staff. A changed approach might reduce or remove the current incentive to maximise the number of delays that are attributed.

4.24 There are arguments for and against a change. We therefore invite parties to submit evidence on whether a changed allocation methodology is appropriate and would deliver significant benefits in terms of the incentives on parties to minimise the delays they cause and also optimise the attribution of delay.

Consultation questions

Question 8: Should Proposal E be a priority for reform in PR23? Are you able to provide evidence on the benefits and costs of the proposal or to inform the allocation of unidentified delays?

F. Reflecting the financial impact of delays on revenues and costs more fully within Schedule 8 payments

4.25 We are also seeking views on whether we should prioritise changing Schedule 8 compensation to more fully reflect the financial impacts of delay, potentially making compensation more accurate and incentivising parties to take account of the full impacts of delays they cause. We invite further comments from stakeholders on whether this change would be proportionate and demonstrate clear value in relation to the regime's objectives and our priorities for PR23.

Current approach

4.26 Schedule 8 payment rates currently reflect the estimated long-term impact of delay on farebox revenues. The logic underpinning this approach is that, if the reliability of a service worsens, passengers will use the service less, for example by switching modes, resulting in lower revenues for operators. Therefore where disruption is caused by other parties, operators are compensated for the expected long-term revenue effect of poor performance. This reduces operators' uncontrollable financial risks, which gives them greater confidence to invest and operate in the industry.

Issues with the current approach

4.27 At present, for passenger operators there is no link between Schedule 8 payments and the cost impacts on operators from delay (such as amounts paid out in passenger compensation). As a result of excluding cost impacts, payments might currently be seen as 'incomplete', not covering the full financial impacts that TOCs experience. This may mean that Network Rail and operators are under-incentivised to consider full financial impacts when making decisions that affect performance, and operators that suffer delays may be being under-compensated. Greater alignment with passenger compensation could help to address confusion that currently exists around the purposes of passenger compensation and Schedule 8 payments.

4.28 The exclusion of some financial impacts from compensation creates the need for a supplementary 'sustained poor performance' (SPP) mechanism, under which operators can claim for additional financial impacts in cases of prolonged disruption. The SPP mechanism carries a significant administration cost to file and agree the terms of claims, and we understand that as a result there have been few successful claims. These costs could be avoided if Schedule 8 compensation was more complete as a matter of course.

4.29 We therefore propose to consider a change to widen the scope of financial impacts within Schedule 8 compensation.

Proposed change F: Reflect the wider financial impacts of delays in Schedule 8 compensation

4.30 Under this proposal, Schedule 8 payments would include cost impacts of disruption[22]. This could include passenger compensation costs and operational costs incurred by victim operators resolving delays (for example the cost of arranging onward road transport for disrupted passengers).

4.31 Network Rail has proposed to us that changing payment rates to be more 'complete' would also allow the existing SPP mechanism to be removed. It argues that the mechanism would no longer be needed if costs were already automatically recovered through Schedule 8.

4.32 This change to Schedule 8 compensation would have the benefit of more completely capturing the financial impacts of delays on train operators, improving the accuracy of the regime and ensuring that operators are fully compensated for

[22] This cost compensation would be in addition to existing revenue compensation, though we invite stakeholder views on whether it remains appropriate to compensate operators for lost future revenues. We also note a likely relationship between a passenger's receipt of compensation and their likely response to disruption – there may therefore be interaction between compensation and future revenues.

delay impacts. This would sharpen the incentives of parties to improve performance and passenger outcomes by considering the full impacts of delays.

4.33 However, the benefits to operators would be limited to the extent that operators are on concession-style contracts that treat Schedule 8 payments as a pass-through and therefore shield them from financial risks. Such a change would also be accompanied by some significant costs in establishing and administering compensation for cost impacts.

4.34 A change to reflect costs within Schedule 8 compensation could be achieved in one of two ways:

(a) **Option F1 – Formulaic recovery.** Under this approach, payment rates would be calibrated to reflect a pre-determined proportion of the cost impacts expected to result from delay. This would require calculations that reflect the average cost impacts (including compensation liabilities) for each service group, which would be a significant undertaking at the calibration stage but would have low ongoing costs to administrate.

(b) **Option F2 – Actual sums recovery.** Under this approach, passenger operators would, on a case-by-case basis, recover from Network Rail the costs they actually incur as a result of delays caused by Network Rail. In principle this would help the sums recovered to be accurate. It would however be a departure from the current 'liquidated damages' nature of Schedule 8, and would involve very significant ongoing administration costs for parties to verify and agree the compensation due[23].

4.35 Our initial view is that we acknowledge some benefits to changing Schedule 8 compensation to more fully reflect the impacts of delays, but there are also downsides. Firstly the change would add complexity and cost to the scheme's calibration and administration[24]. Secondly, it would be likely to raise the sums at stake in Schedule 8, when we have been told that a regime involving large financial sums can be a barrier to co-operation and collaboration.

4.36 At this point we are not persuaded that the benefits of a change outweigh the costs. We encourage stakeholders to share views and evidence, particularly

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[23] The difficulties in agreeing compensation would be akin to those under the current sustained poor performance mechanism, under which operators must, for each case, meet a burden of proof for the financial impacts suffered.

[24] Calibration could be complicated by possible changes in passenger compensation take-up rates due to steps taken in the Williams-Shapps Plan to make compensation "simpler and easier to claim" (page 73).

regarding whether a change could be implemented without raising complexity of calibration and administration.

Consultation questions

Question 9: Should Proposal F be a priority for reform in PR23? If this proposal was taken forward, would you favour Option F1 or F2 to achieve it?

5. Proposals: Freight and Charter regimes

Freight regime: High-level approach

5.1 Stakeholders have told us that the freight regime is broadly fit for purpose – it is well understood, provides useful financial protection to FOCs, in the main it effectively incentivises Network Rail and FOCs to minimise disruption, and it has low administration costs. However, in addition to the cross-cutting proposals in chapter 3, we have identified a further two areas of potential improvement as set out in this chapter.

Consultation questions

Question 10: Do you agree with our preferred high-level approach for the freight regime, to keep the current regime broadly unchanged for CP7? Are there other elements of the freight regime or its calibration that should be considered for reform in PR23?

G. Update to calibration of freight payment rate

Current approach

5.2 In the freight regime, Network Rail's payment rate is designed to reflect the average financial impact of delay on freight operators. However, the evidence base supporting the payment rate was generated in the 2008 periodic review (PR08), and in subsequent control periods has only been adjusted to reflect inflation.

Issues with current approach

5.3 In our stakeholder engagement to date, there has been broad consensus among Network Rail and freight operators that there is value in revisiting this evidence base.

5.4 Freight operators have raised concerns that the Network Rail payment rate has become outdated since its calibration in PR08, and does not accurately reflect the financial impacts freight operators experience when one of their services is delayed or cancelled. The payment rate may not account for efficiency improvements or other changes to costs made after 2008.

Proposed change G: Industry to update evidence base underpinning calibration of freight payment rate

5.5 The evidence base underpinning the freight payment rate is most relevant to the calibration of Schedule 8, which will happen at a later stage of PR23. However, it is important that the industry starts to compile the necessary evidence as soon as possible to allow for analysis and challenge by other parties ahead of calibration. We therefore propose that freight operators, working closely with ORR and Network Rail, begin the process of updating the necessary evidence.

Consultation question

Question 11: Would you support Proposal G, to update the evidence base underpinning the calibration of the freight payment rate?

H. Freight caps

Current approach

5.6 In the freight regime, Network Rail and freight operators have reciprocal annual caps which limit the net annual liability they face. These are intentionally set at a level with a low likelihood of being reached, to ensure that they do not limit the incentive to improve performance. Additionally, operators can choose to purchase an incident cap, effectively a form of insurance which limits the amount they have to pay under Schedule 8 for any single delay incident for which they are responsible.

Issues with current approach

5.7 Network Rail has suggested to us that caps can limit FOCs' incentives to reduce the delay they cause to other parties. Once FOCs hit a cap, they are no longer financially incentivised, beyond their own commercial incentives, to limit the delays they cause. Network Rail considers that incident caps are hit too frequently at present, weakening FOCs' incentives to limit delay; Network Rail considers this implies that caps are not currently determined appropriately and are operating in a way that acts against the interests of users of the railway.

Proposed change H: Revisit calibration of caps in freight regime

5.8 Our view is that caps play an important role in limiting FOCs' financial risks in the context of FOCs being directly exposed to the cost of delay caused to other operators (which currently contrasts with the passenger regime). FOCs typically operate on limited profit margins and are sensitive to exposure to risk; they pay a supplement in order to be able to benefit from caps, with protection provided in return for this supplement. Our initial view is to retain caps in their current form.

5.9 We have not yet seen evidence that the calibration of the levels of supplements and caps is erroneous, but we invite submissions from all parties on whether they are currently determined appropriately. This evidence will help to determine whether the calibration of caps should be revisited.

Consultation questions

Question 12: Should Proposal H, to revisit the calibration of caps, be a priority for reform in PR23? Can you provide evidence demonstrating whether or not the supplements and caps are currently calibrated appropriately?

Charter regime: High-level approach

5.10 The charter sector has its own Schedule 8 regime, which closely resembles the freight regime. Our overall view is that the scheme remains broadly fit for purpose in terms of being well understood, providing useful incentives and having low administration costs. Our initial preference is to keep the current regime in place for CP7. From the cross-cutting proposals in chapter 3, we are currently prioritising one change that could affect the charter regime (Proposal B) and inviting views on one further change (Proposal C). We welcome further input on this from all parties in the charter sector.

Consultation questions

Question 13: Do you agree with our preferred high-level approach for the charter regime, to keep the current regime broadly in place for CP7? Are there other elements of the charter regime or its calibration that should be considered for reform in PR23?

Annex 1: Objectives for Schedule 8 in PR23

Objectives

The following proposed Schedule 8 scheme objectives for PR23 are adapted from the stated purposes and principles of the regime in PR18.

These objectives are:

1. To provide train operators with appropriate protection from losses arising from delays and cancellations outside their control.

2. To provide incentives for the infrastructure manager to improve performance on the network for the benefit of customers.

3. To provide incentives for train operators and freight operators to improve train performance for the benefit of customers.

4. To provide information on the costs of delays to enable efficient allocation of resources.

In addition, the following objectives may be best thought of as ‘constraints’ for the scheme:

5. To avoid undue discrimination between different services.

6. To avoid perverse incentives.

7. To be simple, predictable and practicable.

8. To be resilient to changing circumstances (for example to developments in rail reform).

9. To provide consistent performance incentives across the industry (for example between different industry parties and different industry incentive regimes).

Annex 2: Summary of proposals and questions in this consultation

Proposals

Cross-cutting proposals across regimes

Proposed change A: Base Network Rail's benchmarks only on past performance

Proposed change B: Annual updates to make benchmarks more flexible

Proposed change C: Joint or shared allocation of delay minutes within Schedule 8 itself

Passenger regime proposals

Proposed change D: More accurately incentivise TOCs to limit delay to other operators

Proposed change E: Change the allocation of unidentified delays between Network Rail and operators

Proposed change F: Reflect the wider financial impacts of delays in Schedule 8 compensation

Freight regime proposals

Proposed change G: Industry to update evidence base underpinning calibration of freight payment rate

Proposed change H: Revisit calibration of caps in freight regime

Consultation questions

Chapter 2 – ORR's proposed approach and priorities

Question 1: Do you have any views on the objectives and benefits of a mechanism such as Schedule 8, for the range of different industry parties, both in the current contracting model and once the Rail Transformation Programme has been fully implemented?

Question 2: Do you have any views on whether we should make no changes to Schedule 8 in PR23, or pursue a small number of incremental reforms to ensure it remains fit for purpose as a baseline regime?

Question 3: Do you agree with the areas we have identified as priorities for PR23? Are there any other significant issues that we should seek to address?

Chapter 3 – Proposals: Cross-cutting changes across sector regimes

Question 4: Would you support Proposal A? Do you have any views on the proposed methodology set out?

Question 5: Would you support Proposal B? If benchmarks were to be updated annually, do you favour achieving this through a rolling update (Option B1) or through a modelled approach (Option B2)?

Question 6: Should Proposal C be a priority for reform in PR23? If you would like us to consider Proposal C further, please set out how it can best be implemented (e.g. including incident types that should be subject to joint or shared responsibility).

Chapter 4 – Proposals: Passenger regime

Question 7: Would you support Proposal D, implemented through Option D2? Do you have any views on the options set out?

Question 8: Should Proposal E be a priority for reform in PR23? Are you able to provide evidence on the benefits and costs of the proposal or to inform the allocation of unidentified delays?

Question 9: Should Proposal F be a priority for reform in PR23? If this proposal was taken forward, would you favour Option F1 or F2 to achieve it?

Chapter 5 – Proposals: Freight and Charter regimes

Question 10: Do you agree with our preferred high-level approach for the freight regime, to keep the current regime broadly unchanged for CP7? Are there other elements of the freight regime or its calibration that should be considered for reform in PR23?

Question 11: Would you support Proposal G, to update the evidence base underpinning the calibration of the freight payment rate?

Question 12: Should Proposal H, to revisit the calibration of caps, be a priority for reform in PR23? Can you provide evidence demonstrating whether or not the supplements and caps are currently calibrated appropriately?

Question 13: Do you agree with our preferred high-level approach for the charter regime, to keep the current regime broadly in place for CP7? Are there other elements of the charter regime or its calibration that should be considered for reform in PR23?

Annex 3: Other options considered

We have considered a number of other ideas for reform of Schedule 8 in PR23, but which we are not at this time proposing to take forward. The table below presents ORR's initial views on the merits of these options. We welcome stakeholders' views on these initial assessments and whether the options should instead be considered as priority areas for reform in PR23.

No.	Idea	Description	Initial assessment
1	Benchmarks: Exclude enhancements from Network Rail performance trajectories	Currently Network Rail's benchmarks are intended to reflect the impact of enhancements which improve performance. <u>Excluding</u> effects of enhancements would provide a Schedule 8 performance bonus to Network Rail if it beats its benchmarks due to an enhancement, effectively sharing the cost of funding enhancements with TOCs.	Network Rail is already funded to deliver enhancements through its overall settlement, so there is not an additional need for funding through Schedule 8. A bonus achieved through Schedule 8 for resulting performance gains could mean that Network Rail is funded twice for the same enhancement. Also note that Proposal A is to base Network Rail's benchmarks on historical performance, which would mean that any future enhancement plans were already not reflected in benchmarks.
2	Payment rates: Lower, more tokenistic, payment rates	The link between payment rates and financial impacts could be removed, with payments being more tokenistic. This is the approach followed in some European regimes.	This would reduce the sums at stake, which could encourage collaboration. But it would also substantially reduce incentive effects and important financial protection offered by the regime.
3	Cross-cutting change: More aggregation in calibration	Calibrate passenger regime at a more aggregated level rather than at TOC service group – in extremis at level of whole sector. This would move the passenger scheme closer to the freight scheme.	This would simplify the passenger regime, reducing complexity in its calibration. But it would reduce the scheme's accuracy, potentially weakening incentives for individual service groups, and could result in a scheme that, for any individual operator, would not be neutral on expectation.

No.	Idea	Description	Initial assessment
4	Cross-cutting change: Benchmarks and payment rates to be set by negotiation	Parameters would be set by negotiation between Network Rail and operators – this is a feature of some European regimes.	This could leave operators exposed to unfavourable outcomes given imbalance of power and information in negotiation. In addition, negotiation process could be lengthy and administratively burdensome.
5	Cross-cutting change: Increase frequency of monitoring points	This would raise the number of points at which delay is measured to cover any station stop, fine-tuning the current system.	This change could somewhat improve accuracy and improve incentives to reduce customer impacts of delays. However, it may add cost and complexity.
6	Measure of delay: Dead-bands	Payments would not take place in relation to small fluctuations from benchmarks. This is a feature of some European schemes.	This would reduce the number of incidents that resulted in Schedule 8 payments, and therefore reduce the sums at stake and some of the scheme administration costs. But this would also reduce incentives to limit small delays, which are an important aspect of train performance.
7	Measure of delay: Sharing reactionary delay	Network Rail and operators would share in each other's reactionary delay – in Schedule 8 a set proportion of Network Rail's reactionary delay would be automatically allocated to the TOC – and vice versa.	Proposal could improve a party's incentive to recover quickly from incidents regardless of who caused it. However, this reduces a party's incentives to avoid causing delay in the first place; system would inevitably be somewhat arbitrary.
8	Structure of scheme: No payments for TOC-on-TOC delay	There would be no payments in relation to TOC-on-TOC delay. This is a feature of some European schemes.	This would be a sizeable shift that would considerably simplify the regime, reducing complexity in the star model. However, it would remove incentives on TOCs to limit delay caused to others, which could lead to greater disruption.
9	Structure of scheme: No bonuses in scheme	Scheme would feature compensation only – no reward for outperformance. This is a feature of some European schemes.	This would somewhat simplify the regime, but would remove Schedule 8's incentives to outperform benchmarks and therefore be adverse for train performance.